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Principles of a Development Round

We begin with an analysis of the principles that should underlie a development round of trade negotiations. It seems self-evident that:

1. Any agreement should be assessed in terms of its impact on development; items with a negative effect on development should not be on the agenda.
2. Any agreement should be fair.
3. Any agreement should be fairly arrived at.
4. The agenda should be limited to trade-related and development-friendly issues.

While these principles may be widely agreed on, there may be important differences both about the meaning of terms and about how to respond to conflicts among the principles.

4.1. Any Agreement Should Be Assessed in Terms of its Impact on Development

Any agreement should be carefully designed to promote, not hinder, development. There is surprisingly little economic analysis of the precise consequences of various potential trade agreements on participant countries. Where analytical studies have been made, they have not penetrated into the core of negotiations and they do not seem to play a central role in setting the agenda. The absence of this type of analysis begs the question of what is driving the prioritisation of trade issues on the WTO agenda other than a mélange of prevailing orthodoxies and the momentum of special interest groups.

The WTO Secretariat should be responsible for producing a *general equilibrium incidence* analysis, analogous to the analysis made when taxes are imposed, attempting to assess how different countries are affected by different proposals. Publicly available analysis would benefit developing countries, many of who are at an information disadvantage relative to developed countries. Publicly available information would also be an important source for consumers, who are less equipped to lobby for favourable outcomes than producer groups.

Analysis based on general equilibrium models must be sensitive to the fact that *different developing countries are likely to be affected differently, and different groups within developing countries are likely to be affected in different ways.* Thus, eliminating developed country agricultural subsidies is likely to benefit grain exporters, but hurt grain importers. It is likely to benefit grain producers, and hurt grain consumers. What is particularly problematic is that within developing countries, grain producers are among the poorest people, so they are the ones most likely to benefit, even if the country *as a whole* is a grain importer, so the country as a whole loses. Moreover, within most developing countries, there are limited mechanisms of redistribution, so that it does not suffice to assess what happens *on average*.

The results of general equilibrium models are sensitive to their assumptions. Much of the analysis of the impacts (including, for instance, judgements about whether particular types of agricultural subsidies are trade distorting) relies on a particular model of the economy, the neoclassical model, which assumes full employment of resources, perfect competition, perfect information and well-functioning markets, assumptions which are of questionable validity for any country, but which are particularly problematic for developing ones.

Most of the tools used to analyse the general equilibrium effects of trade liberalisation are static models. They describe the movement from one 'steady state' to another, but do not incorporate the costs associated with transition or the consequences for economies which are initially out of steady state. For example, the models typically assume that there is full employment. Trade liberalisation measures are good for a country because they enable resources to be redirected from low productivity protected sectors to more productive sectors as the economy specialises in its areas of comparative advantage. Under full employment, developing countries would unambiguously benefit from trade liberalisation measures, were it not for terms of trade effects (changes in relative prices). Most of the studies cited in the Appendix that assess the impact on developing countries thus focus principally on these terms of trade effects.

But if there is not full employment, trade liberalisation may simply move workers from low productivity protected sectors into unemployment. This lowers the country's national income and increases poverty. There can be multiplier effects, so that the total impact is far greater than the direct effect. Much of the opposition to trade liberalisation arises because of the perceived effects on unemployment. In more developed countries, monetary and fiscal policy should, in principle, enable the country to maintain close to full employment. As the advocates of trade liberalisation repeatedly emphasise, the objective of trade liberalisation is not to create jobs, but to increase standards of living by allowing countries to specialise in areas of comparative advantage. But in many developing countries which have persistent unemployment – with unemployment rates in excess of 20 per cent[34] – it is evident that monetary and fiscal polices are unable to maintain the economy at full employment. While the standard neoclassical models typically employed to assess trade impacts do not identify the impact of trade liberalisation on the equilibrium level of unemployment[35] – by assumption there is none – even if trade liberalisation had no impact on the *equilibrium* level of unemployment, it may take the economy a considerable time to adjust, and the costs of adjustment – in lost income and increased poverty – may be considerable.

Another important assumption made in most of the analyses is that there is no uncertainty and no risk. But *changes in trade regimes affect countries' exposure to risk.* In the absence of good insurance markets, there can be first order welfare effects arising from this increased exposure to risk.[36] For instance, with a quota, those who compete with imports know precisely how much will be imported and therefore, if there is relatively little domestic volatility, they will face relatively little price uncertainty. But with the tariffication of quotas, countries are exposed to considerably greater volatility.[37]

It is important that any incidence analysis takes into account other pre-existing distortions. For instance, tax policies (often advocated by international institutions) which effectively tax the informal sector less than the formal sector, already distort production in favour of the informal sector. In this context, trade regimes which further lower the international price of agricultural goods, typically produced by the informal sector, have a larger adverse effect than would be the case if tax policy were more neutral.

It is also important that any incidence analysis be based on an assessment of the *global general equilibrium impacts*, which takes into account the effects of a change in a trade regime on global relative prices. For instance, if a single small country were to subsidise cotton, it would have a relatively small effect on the global price of cotton. But if a large producer – for example the United States – subsidises cotton, it has an effect on its international price.

The fact that implementation and adjustment costs are likely to be larger in developing countries, unemployment rates are likely to be higher, safety nets weaker and risk markets poor are all features that need to be taken into account in conducting a relative incidence analysis. If trade liberalisation has a large effect on inequality, then governments may be required to strengthen their redistributive welfare system. Larger taxes generate increased deadweight loss, which reduces the efficiency gains from liberalisation.

Large adjustment costs imply not only that the process of liberalisation should be conducted gradually, but also that there should be no oscillations. Bilateral agreements *on the way to a multilateral agreement* may be particularly offensive when there are important elements of trade diversion. The greater adjustment costs in developing countries may mean either that the net benefit (net of the adjustment costs into and out of the sector having temporary preferential treatment) may be small and/or that there will, in fact, be relatively little benefit, as expansion into that sector may be limited, as investors recognise its short-term nature.

Finally, it is of first order importance to distinguish between provisions which should, in principle, make a country better off on its own, almost regardless of the circumstances, provisions which might or might not make a country better off on its own, and provisions which essentially are *redistributive* in nature, with the gains to one side being largely offset by losses to the other. We have argued that many trade liberalisation measures would, in a world of full employment, make a country better off on its own. In this world, the question is often posed: why is there any need for a trade agreement? Trade agreements are used only as a bargaining weapon; the threat of not opening up one's own market (which has a cost) is used to force the opening up of the foreigner's market.

Note that many of the arguments that are currently used in favour of certain provisions of proposed trade agreements contend that they are good for developing countries.[38] To the extent that such arguments are correct, of course, they imply that there is no need for a trade agreement, other than the *political economy* argument that it is only by bringing pressure from the gainers from trade liberalisation that one can overcome the resistance of the losers in a world in which compensations are typically not made. Moreover, to the extent that such arguments are correct, they imply that (apart from global terms of trade effects) the issue of fairness only pertains to the distribution of *relative* gains (relative costs and benefits) since *every country* benefits. This also means that any country could unilaterally increase its gains simply by lowering its trade barriers further, thereby expanding trade. To be sure, some of the opposition to trade liberalisation comes from those who would be hurt by it, especially special interests who benefit from protection; but some opposition may arise because particular countries may be adversely affected *as a whole*.

These cases need to be distinguished from intellectual property rights, where stronger Intellectual Property Organisation (IPO) protections may increase the incomes of those in the more advanced industrial countries *at the expense of those in the less advanced industrial countries*. Here, the issue is primarily redistributive, and is accordingly fundamentally different from issues that arise in connection with trade liberalisation.[39] Again, the developed countries make a self-serving argument that stronger IPO protections will: (a) induce more research; or (b) induce more investment in intellectual property intensive industries. There is relatively little evidence that the incremental profits generated in developing countries, for most goods, has much impact on research. This is certainly the case for most drugs, where the overwhelming bulk of the profits are generated by sales in the North, and the drug companies do little research related to illnesses the primary incidence of which is in the South. In many areas, such as soft drinks, trade secrets, not patents, have been the basis of expansion into the South. In any case, if it were true that stronger intellectual property protections led to faster growth, countries interested in enhancing growth would on their own provide stronger protection.[40]

4.2. Any Agreement Should Be Fair

This is perhaps the principle which is most difficult, but also the most important. Underlying conflicts about perceptions of fairness is the fact that *because the circumstances of the different countries are different, any agreement that applies 'fairly' or 'uniformly' to all countries may still have large differential effects*. This is why we have emphasised the importance of an incidence analysis – an assessment of the differential effects on different countries. *Any agreement that differentially hurts developing countries more or benefits the developed countries more* (as measured, say, by net gains as a percentage of GDP) *should be* *presumptively viewed as unfair*. Indeed, it should be essential that any reform is *progressive*, i.e. that a larger share of the benefits accrues to the poorer countries. This was almost certainly not true of the Uruguay Round.

There is a key difficulty in interpreting this requirement. Many of the costs of, say, agricultural subsidies are borne by the developed countries. Not only are there huge budgetary costs associated with the subsidies, but the subsidies distort production and thus there is a deadweight loss associated with them. So if developed countries were to eliminate their subsidies, the developed countries as a whole would be among the main beneficiaries. Thus, a refinement of the above criterion would look at the benefits granted to others: in competitive markets, it would be reflected in the general equilibrium terms of trade effects received by producers or paid by consumers; in non-competitive markets, or markets with quota restrictions, it would be the value of access granted.

One particular aspect of this should be emphasised: in trade disputes, both *de jure* and *de facto*, the more developed countries are in a better position to prevail. Thus, the costs to a developing country of attacking a claim of intellectual property rights by a Western company in a case involving bio-piracy[41] may be very high; in practice the developing country is at a disadvantageous position in any process entailing resort to complicated and expensive legal proceedings.

More generally, the WTO dispute system favours rich countries with the resources to use it effectively in their own interests. The European Commission, Japan and the United States were complainants in almost half (143 of 305) of all bilateral disputes in the WTO dispute settlement system between 1995 and 2002. In contrast, in the same period the 49 members classified by the UN as less developed countries did not bring a single challenge.[42]

Within developed countries there is a long history of those in positions of power using the legal system to maintain their privileges. More recently, many developed countries have tried to come to terms with the resulting inequities by providing public legal assistance. Typically, because of the relatively low pay of those employed to provide such assistance, this can go only a little way towards redressing the imbalance. But at a minimum, the developed countries should provide assistance to the less developed countries in helping create a more level playing field.

By the same token, even if a developing country were to prevail in a WTO tribunal against the United States or the European Union, the enforcement system is asymmetric, and consequently unfair. The sanction for violating a WTO agreement is the imposition of duties. If Ecuador, say, were to impose duties on goods that it imports from the United States, it would have a negligible effect on the American producer; but if the United States were to impose a duty on goods produced by Ecuador, the economic impact could be devastating. In practice, the WTO system has no effective way of enforcing a ruling against an unfair trade action, the main impact of which is on small developing countries. When, of course, a major industrial country takes a global action

– such as the US imposition of tariffs on steel – then there can be global retaliation and, as we have seen, this can induce a response.

But the other side of 'fairness' is *the initial condition*. Currently, developing countries have higher tariffs than developed countries.[43] The US might claim that it is only fair that developing countries cut their tariffs proportionately; this would entail a greater amount of tariff reduction by the developing countries – and accordingly the costs to the developing countries might be greater. But the developing countries also point out that *at the very least* the principle of progressivity should rule out adverse discrimination against developing countries. Yet, currently, the developed countries impose higher tariffs against developing countries than they do against other developed countries, even taking into account the so-called 'preferences'.

Balancing these concerns are factors involving historical inequities. If a country's relative weakness is in part due to its colonial heritage or, more pertinently, to earlier unfair trade agreements (for example the situation resulting from the Opium War in the nineteenth century in China), to what extent do fairness and equity demand that current agreements reflect these past injustices? Trade negotiators from the North would like to pretend that such inequities never occurred. Those from the South might argue that one cannot separate events today from the historical context.

The nature of trade agreements is, of course, that not every provision in the agreement will be 'fair'. Some provisions are intended to give more to one party, others to another; it is the package as a whole which should be viewed as fair. But each agreement is forward looking; there are implicit and explicit understandings about the direction of future agreements. After the Uruguay Round, there was a clear understanding that there would be further liberalisation of agriculture, and there was a presumption that textile quotas would not simply be replaced by high tariffs, but that this market too would be opened up. In the case of agriculture, there is a strong sense that the United States has reneged on this commitment; whether the huge increase in agricultural subsidies is an explicit violation of earlier agreements is of less importance than that it represents a violation of the *spirit* of the agreement (or what should have been the spirit, or what at least was taken to be the spirit by the developing countries). Just as the agreement should be viewed as a whole, so too a development round agreement should be viewed in the context of the unbalanced agreements that preceded it.

4.2.1 Fairness between Foreign and Domestic Producers

While most of the discussion in this paper concerns 'fairness' *among countries*, there is a related issue – fairness between domestic and foreign producers. One of the purposes of trade liberalisation is to ensure that foreign producers are treated 'fairly.' But again, there are questions as to what this really means. Foreign producers and domestic producers are often in inherently different situations. The foreign producer (in the case of manufacturing in a developing country) may have greater access to capital. He almost surely has greater access to international technology. Much of the debate about protection concerns 'levelling the playing field', correcting these initial inequities.

Most of the economics literature eschews the 'fairness' vocabulary in favour of the language of efficiency. Protecting domestic firms is *inefficient*; a country would be better off if it did not protect them. But for reasons hinted at above, these arguments are contentious. There may be important learning benefits from protection. And while economists have typically argued in favour of open subsidies and/or government loan programmes, rather than the hidden subsidies provided by protection, direct subsidies may, for a variety of reasons, be difficult or impossible to implement. In a second-best world, some protection may be efficient.[44]

Thus, both the efficiency and the fairness arguments are contentious. But what cannot be justified are developed country non-tariff barriers, such as dumping, which treat developing country producers disadvantageously relative to producers in developed countries and subject them, for example, to a far higher standard in relation to what amounts to predatory behaviour than that to which their own firms are subjected.[45]

By the same token, it is hard to justify asking developing countries to provide *foreign* firms with *greater* protection than that provided to domestic firms. While there is some debate about the validity, or abuse, of the infant industry argument, there is no argument for protection of a 'grown-up industry'.

So too, the US has found it desirable to impose lending requirements on its banks, to ensure that they provide capital to under-served communities through the Community Reinvestment Act. Such measures recognise that there is a role for government in encouraging particular sectors of the economy. It seems *unfair* (and inefficient) to preclude developing countries from undertaking analogous measures.

4.2.2 Other Problems in the Interpretation of Fairness

One of the most difficult issues is how to treat policy failures within each of the countries. Suppose that it is true, as asserted earlier, that the Uruguay Round in fact differentially benefited the United States. But suppose the imbalance could have been reduced if only the developing countries had *reformed* their economies. They might, for instance, have been able to benefit more from the reduction in tariffs on manufacturing, if they had invested more in infrastructure and thus been able to attract more manufacturing.

By the same token, to what extent should the international trading regime be *blamed* for inequities which arise, in part, because of how other parts of the international system operate? Suppose, for instance, that a 'fair' trade negotiation occurs within the WTO, but that after the negotiation is over, the developing country has to turn to the IMF for assistance and the IMF imposes further trade liberalisation as a condition of assistance. Viewing the two negotiations together, as a package, clearly the developing country may have given far more than it got within the trade package, but, of course, it received in addition some foreign assistance. (Admittedly, in the case of many of the bail-outs, the primary beneficiary may be banks in the more advanced industrial countries.) But even apart from these demands that are put to developing countries, the United States makes demands on other countries (section 301 and super 301 actions),[46] to which they often feel compelled to accede. Thus, even if the trade agreements that were reached were fair, what happens afterwards upsets the balance. And when the initial trade agreement was unfair, the inequities are all the greater.

Similarly, when international institutions encourage tax policies which have the effect of distorting production towards the informal sector, this implies, as noted above, that the West's agricultural subsidies have a greater adverse effect on the developing countries than they otherwise would have had. In discussing the inequities of the trade regime, should we assess its fairness, coming on top of distortions imposed or encouraged by the North, or should we discuss it in terms of what the incidence would have been, if a more neutral tax system had been imposed? Should we view the two actions together, assessing the incidence of the two policies in conjunction, or should we only assess the fairness of the trading regime itself?

By the same token, when countervailing duties are imposed against a developing country that has 'subsidised' interest payments by bringing them down from the usurious levels insisted upon by the IMF to levels still slightly higher than those in international capital markets, is this unfair? Should the government only be viewed as undoing a distortion? The problems are exacerbated by demands (included in the recent bilateral trade agreements between the United States and Chile, and the United States and Singapore) for capital market liberalisation. Capital market liberalisation increases economic volatility,[47] and increased economic volatility increases the risk premium that investors demand,[48] effectively increasing the interest rate charged. It seems unfair to force upon developing countries provisions which effectively increase the interest rate they have to pay, and then when their governments try to undo the consequences, to slap a countervailing duty upon them.

In the South, of course, there is a tendency to see the actions as co-ordinated, driven by economic interests in the North. While observers in the South may see more co-ordination than actually occurs, the impacts are often closely akin to what they would be if they were co-ordinated. The high interest rates, tax policies and trade liberalisation policies demanded by the IMF do exacerbate the effects on developing countries of whatever trade liberalisation measures they agree to within the WTO. These factors cannot be seen in isolation. This provides the basis of one of the important recommendations that we make below.

With such disparate views of fairness, it is no wonder that the South may feel that a trade agreement proposal is grossly unfair, and yet the North may feel no pangs of conscience. Some might conclude that, as a result, we should simply drop the criterion of equity from the desiderata of a development round agreement. That would be a mistake. In a democracy, any trade agreement must be freely entered into, and the citizens of the country must be persuaded that the agreement is essentially *fair*. Moreover, there are several widely accepted philosophical frameworks – in particular that of Rawls[49] – which are widely accepted, and that at least provide some guidance for thinking about whether or not an agreement is fair.

4.3 Any Agreement Should Be Fairly Arrived At

This is often referred to as *procedural justice*. It becomes an important complement to the kind of fairness discussed in the preceding section when there is some ambiguity about what is meant by 'outcome fairness'.

Procedural fairness focuses on the openness and transparency of the negotiation process, and the manner in which the discussions are conducted. There is now a large literature which establishes that the way in which the agenda is set may have a large effect on the outcome; hence having a voice in the setting of the agenda is essential. The agenda in previous trade negotiations has been unbalanced: issues of benefit to the developed countries have been at the centre of the discussion; issues such as the liberalisation of skilled labour services have been on the agenda; and issues such as the liberalisation of unskilled labour-intensive services have been missing.

Transparency is essential because it enables more voices to be heard in the negotiating process and limits abuses by the powerful. This is particularly important for developing countries, because of the limited size of their negotiating teams. Of particular concern is the lack of transparency of the 'green room' negotiations in which only a few chosen countries from the developing world engage in negotiations with the US and Europe. The 'green room' process limits outside scrutiny and places the developing countries in a disadvantageous position because of the complexity of the negotiations and their limited staffs.[50] Procedural fairness needs to deal with the asymmetry of power and the asymmetry of information among WTO members. While the effect of power disparities are difficult to reduce, informational disadvantage can be remedied.[51]

The processes for adjudicating disputes also often lack the protections that we have come to expect in a modern democracy. Under the North America Free Trade Agreement (NAFTA), for instance, there is no appellate process that affords the same guarantees for the public interest as there is in the case of issues that concern domestic investor protection.

Indeed, the very distinction between the manner in which *international* rules are arrived at and the manner in which domestic rules are determined, reflects the lack of democratic guarantees. Within a country, there are parliamentary processes. These processes involve negotiations, but they are not just a negotiation between the interested parties. Labour legislation, for instance, is not negotiated by business and labour, although the views of both are listened to carefully. At the international level, there is no analogous parliamentary body. There is a 'negotiation'. In the past, the terms of the negotiation have largely been set by the United States and Europe. The negotiators' mandate is to get the best deal for their country, using whatever tactics they can employ, whether it be threats, promises, secret meetings, etc. This contrasts markedly with, at least, the language used in parliamentary processes, where the objective is to find a set of rules and regulations that is *fair* and *efficient*. The participants in the discussions, while mindful of the interests of those they represent, defend their positions in terms of principle, and look for principled solutions, reflecting social justice and solidarity.

4.4. The Policy Space Should Be Interpreted Conservatively

Defining the policy space appropriate for attention within the WTO is a difficult task. There has been a tendency to expand the WTO's agenda to include all manner of international problems from intellectual property rights to protection for foreign investors. The international community has found that bringing formerly intractable international issues within the ambit of trade provides both a convenient negotiating forum and a ready mechanism for enforcement of agreements. If the only test of inclusion in the agenda is that a policy must affect trade flows, then the boundaries of WTO activity are very hard to define because almost all international problems can be linked to trade flows in some way. In this regard, policy-makers have liberally employed the prefix 'trade-related aspects of' to pragmatically expand the WTO's mandate into a growing number of issues.

However, the growth of the WTO's policy space comes at a price. First, developing countries have limited capacity to analyse and negotiate over a large range of issues. Second, the experience of the Singapore issues suggests that larger agendas burden the negotiations. Third, the expansion creates room for developed countries to use their superior bargaining power in trade negotiations to exploit developing countries over a larger range of issues. For instance, when the agenda was extended to competition policy, the issues relevant to the foreign business interests of developed countries became the main focus of negotiations, while insufficient attention was given to key areas of concern for developing countries, such as rules against predation and the development of global anti-trust enforcement. Similarly, the focus of intellectual property negotiations has been determined by the pharmaceutical industry in the industrialised world. Almost inevitably, the determination of these issues will reflect the consequences of the exercise of power.

For these reasons a 'principle of conservatism' needs to be introduced to guide the growth of the WTO's mandate. Further issues should only be included in the agenda of a development round if they score highly on three criteria: (i) the relevance of the issue to trade flows; (ii) its development friendliness; and (iii) the existence of a rationale for collective action.

This third element reflects a general presumption in favour of national sovereignty. There is no reason to force nations to undertake certain actions unless their actions have effects on the trade of others which require collective action to resolve. There are areas in which trade agreements are absolutely essential. These include an international rule of law (procedures) for dealing with trade disputes and agreements to prevent beggar-thy-neighbour trade policies. There are areas in which international agreements would be beneficial to manage cross-border externalities or global public goods.[52] But modern trade agreements have been extended into areas which intrude into national sovereignty with no justification based on the need for collective action and without clearly identified and fairly distributed global benefits.[53] The presumption of consumer sovereignty is based on the premise that society should only interfere with individual choices when those choices have consequences for others, so that there is a need for collective action; the same is true in trade.

4.5 Some Implications

The above principles have immediate implications for the *structure* and *design* of any development round agreement and process, several of which we have already touched upon. Among the more important are the following:

1. *The scope of the agreements should be relatively limited, with first priority going to areas where collective action is absolutely required.*
   a. There is a need to revisit TRIPS.
   b. Few, if any, of the Singapore issues meet this criterion.
   c. Restrictions should be placed on *investment competition*; this is more important than negotiations over *investment protection*.

2. *The priorities for trade liberalisation should reflect the development concerns of the poorer countries.*
   a. There is a need to revisit sectoral priorities (agricultural versus services; labour versus capital).
   b. There is a need to revisit the priorities within sectors (unskilled service intensive sectors versus skilled service intensive sectors).
   c. There is a need to revisit the use of non-tariff barriers (dumping, safeguards and countervailing duties).
   d. There is a need to revisit the issue of subsidies:
      i. Are some of the so-called non-distorting agricultural subsidies really distorting?
      ii. Should some prohibited subsidies be allowed in developing countries?
   e. There is a need to revisit the issue of how countries respond to crises.
   f. There is a need to analyse trade policy within the context of the broader international context.