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Welfare Effects of the GATT System

by Ulrich Müller, Cologne*

The GATT Conference of Ministers scheduled for November will have to deal with those developments of recent years which have given cause to believe that GATT is increasingly being adapted to the trade practices of its signatories rather than itself serving as their guiding principle. Does such a trend in fact exist and, if so, what are its effects on the member states' welfare?

Following almost six years of painstaking efforts the Tokyo round of GATT negotiations was completed in April 1979. Tariffs were reduced on average by a third, and codes were agreed upon with regard to government procurements, customs valuation, subsidies, countervailing duties and non-tariff trade barriers. The existence of manifold provisions for exceptions, however, together with other factors, is reason enough to view any general optimism regarding the GATT's international trade regulations¹ with scepticism.

During the negotiations the contracting parties avoided dealing with pressing issues of trade policy, such as the problem of the quasi-sovereign regulation of markets by government agreements². This evasion means that the ever-increasing number of *informal* voluntary agreements on self-restraint continue to be tacitly tolerated. In addition, *formal* changes to the original agreement have also been effected. Subsidies, for example, are in certain cases expressly recognised as an instrument of national economic policy, whereas the original General Agreement on Tariffs and Trade can be interpreted as being against the use of subsidies³. Furthermore, the legalisation of tariff preferences for developing countries via the so-called "Enabling Clause", represents the cementation of a further deviation from the most-favoured-nation principle, a deviation which up to then, via the use of a waiver, had had more the character of a transitional measure.

There is therefore cause to believe that GATT is increasingly being adapted to the trade practices of its signatories rather than itself serving as their guiding principle. If this were true, it would have long-term implications for the welfare positions of the participating

states. It should therefore be examined whether there is indeed a trend away from the GATT rules and, if so, what effects this has on the respective welfare of its members. For this purpose it is necessary to deal briefly with the actual set of agreements and the possible welfare effects contained therein.

The GATT Principles

GATT came into effect in 1948, marked by the experiences gathered between the two World Wars. This period was characterised internationally by mutual mistrust in matters of trade and monetary policy, sudden revocations of bilateral trade agreements, and an intensification of tariff protectionism, which in some cases led to a policy of autarky⁴. As a result, the GATT system was based on the principle of multilateralism. Its guiding principle is non-discrimination. It is incorporated in the most-favoured-nation clause (Art. I) and binds the contracting parties to grant concessions which have been granted to one member country to all other member countries without reservations. The most-favoured-nation clause, which thus determines the *competitive relationship of the various foreign suppliers* on an importing country's market, is logically complemented by the second basic GATT principle of

¹ Cf. e.g. Wedige von Dewitz: Die multilateralen GATT-Verhandlungen (The Multilateral GATT Negotiations), in: WIRTSCHAFTSDIENST, Vol. 59 (1979), p. 346-350.

² For a more detailed discussion cf. Bernd Stecher: Zum Stand der internationalen Handelspolitik nach der Tokio-Runde (International Trade Policy after the Tokyo Round), Kieler Diskussionsbeiträge 69, Kiel 1980.

³ Cf. Jan Tumlir: Die Weltwirtschaftsordnung heute: Eine kritische Bestandsaufnahme (Today's International Economic Order: a Critical Appraisal), in: Zwischenbilanz der Diskussion über eine neue Weltwirtschaftsordnung, Symposium VII der Ludwig Erhard-Stiftung, Stuttgart, New York 1981, p. 9-23, here p. 14.

⁴ Cf. Wilhelm Röpké: International Economic Disintegration, 3rd ed., London 1950.

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equal treatment of domestic and foreign goods with respect to domestic levies and legal provisions (Art. III). This prevents both the different treatment of the various foreign imports and any discrimination of foreign goods compared to domestic goods on the domestic market. The objective of both principles is to enable and to maintain free-market competition in international trade. In addition, the international competition mechanism is to be guaranteed by the prohibition of quantitative restrictions (Art. XI), dumping (Art. VI) and subsidies which impair the interests of other contracting parties (Art. XVI). Tariffs as obstacles to trade are tolerated in principle. However, GATT emphasizes the need for their removal (Art. XXVIII). Tariff increases are made more difficult: if a country intends raising the tariff on a particular product, it is obliged to compensate the contracting parties affected by granting them additional concessions on other areas. Thus, a liberalisation level, once achieved, is to be maintained.

Safeguards and Conflicts

The founders of GATT were well aware of the fact that during the period of post-war reconstruction of the international economy and the period thereafter certain states could be confronted by trade situations which would make it difficult or temporarily even impossible for them to meet their contractual obligations. Examples are dumping policies by other countries, balance-of-payments problems or the short-term threat to the existence of domestic industries posed by foreign suppliers. So as not to endanger the agreement as a whole in such cases, resulting for example from unilateral restrictive measures by the country affected, various safeguard clauses were incorporated. Depending on the exact nature of the problem, the contracting party is allowed to impose anti-dumping duties (Art. VI), to introduce quantitative trade restrictions (Art. XI), or restrictions to safeguard the balance of payments (Art. XII) or indeed to discriminate against imports of individual trading partners (Art. XIX/XX). These measures can only be implemented, however, following preliminary consultation with the other members. Their application is subject to approval and must be applied for anew after a certain period. This means that the exceptional trade-policy provisions are placed under multilateral control.

Despite the possibility of invoking safeguard clauses in economically exceptional situations, it was not possible at the time GATT was introduced to guarantee that individual contracting parties would not break the agreement unilaterally and set up trade barriers. In such a situation, GATT envisages consultations between the

countries concerned. Should bilateral agreement prove impossible, the other contracting parties are to be asked for their opinion. This procedure has as its goal the elimination of the illegally induced disruption of international trade relations. Only in particularly serious cases can the country affected be relieved of its contractual obligations vis-à-vis the country guilty of such protectionist activities. Should an agreement on the elimination of the contractual breach prove impossible, this could result in the exclusion of one of the contracting parties (Art. XXII/XXIII).

This concept makes clear GATT's intention: to create an orderly basis for international trade relations. The rules themselves, which determine which trade-policy measures are allowed and which are not, go towards reducing the chances of mistakes being made with regard to the admissibility of certain interventions, thus reducing conflicts. The agreement is thus in no way based on the naive belief in boundless harmonious relations between its members. On the contrary, conflicts and the associated settlements are central features of the GATT framework. This goes towards preventing a situation in which differences of opinion in trade policy between two contracting parties are resolved in an uncontrolled manner *outside* of the Agreement by resorting to trade barriers on the one hand, and retaliatory measures on the other.

Admittedly, each member country is still in a position to ignore the GATT stipulations and react to the interference of trade by another country by implementing the sanctions it deems suitable. However, were a relatively large number of the contracting parties to behave in such a manner, international trade would thus be disrupted by measures which have been left to the discretion of each individual member. This would result in mutual discrimination, and would destroy the system based on non-discrimination. The fear of the contracting parties of such a consequence, which would mean a relapse of international relations into the state in which they had found themselves during the inter-war period, forms a stabilising element of the GATT system⁵. The General Agreement on Tariffs and Trade is not just worth keeping for its own sake, but also because it can contribute to enhancing the welfare of its individual members. In order to assess the extent to which deviations from the basic principles could adversely affect this possibility, the potential welfare effects must first be illustrated.

⁵ Such a situation in which each party can eliminate the advantage gained illegally by the other party by violating accepted rules, and in which each party's payoff is smaller than if they were to play to the rules is referred to in decision theory as the prisoner's dilemma.

GATT's Welfare Effects

The immediate welfare effects of this trade system are to be seen in the fact that government transaction costs are reduced, costs which would have ensued in full had the General Agreement on Tariffs and Trade not been established: via the accession to GATT and the acceptance of its principles each contracting party supplies the other members with information concerning its future line in trade policy. Since each government has to have basic confidence in the assurances given by others that they do not intend to employ discriminatory measures or to create trade barriers – if the Agreement is to be of any value at all – a situation in which GATT exists has the advantage of saving information costs concerning any new trade barriers which may have been raised. In addition, costs of diplomatic intervention aimed at removing possible disruptions of international trade can be saved. The only exception is if consultations have to be made under Articles XXII/XXIII.

Such advantages could of course be achieved by bilateral agreements. However, due to the most-favoured-nation clause, the concessions granted by a government to one of its trading partners are immediately valid for all the others. To begin with, this means that, as opposed to bilateral arrangements, control costs for international goods traffic, expenditure for country of origin labelling and similar costs, which would result from unequal treatment of the various trading partners, do not arise. It also means that trade can be liberalised by just two contracting parties negotiating. Taking into account the fact that GATT had 86 full members and 2 provisional members in 1981, not to mention the 30 countries which de facto employ its rules, the lack of a most-favoured-nation clause would necessitate more than 6,900 separate bilateral agreements to achieve the same effect. It is obvious that the GATT procedure saves considerable negotiation and settlement costs compared with bilateralism. Since GATT also contains *abstract* stipulations to guarantee the smooth running of international competition in general, it is not necessary to negotiate each individual case of international goods traffic, these costs therefore being non-recurring. This also applies to firms wishing to export goods to a contracting party's country, repeated expenditure for information on changes in import regulations again being unnecessary.

Even more important is the fact that the consistent application of GATT virtually eliminates the *uncertainty* for firms in the exports field as regards the possibility of a *sudden change in the course of trade policy* in the

importing country. The risk of new installations suddenly becoming economically obsolete due to the creation of high trade barriers is considerably diminished by the GATT set-up. With trade policy a known quantity, risk expectations are reduced to the market risk already known to the firm, and no longer relate to the potentially prohibitively large uncertainties concerning sudden changes in trade policy⁶. The elimination of such incalculabilities in foreign trade policy has removed a large obstacle to trade and investment. This increased certainty allows investments to be carried out which enable a better, or even complete (in the case of free movement of goods), utilisation of economies of scale, leading to an improved specialisation and allocation of resources on an international level. Such a trade system thus creates the preconditions for both improving allocational efficiency and intensifying competition. Under these conditions the international system of competitive prices provides the entrepreneurs with information as to the attractiveness or the necessity of making changes in their production. If the individual entrepreneur does not readjust in time, foreign competition could force him into insolvency. On the other hand, if he is quick to change his production procedure or diversify his range of products, he stands a good chance of greater profits.

These results would indicate that the GATT system is particularly conducive to promoting entrepreneurial initiative. Admittedly, existing tariffs limit international freedom of contract for the supply and demand sides alike. More important, however, is the fact that the *concept* of GATT restricts the possibility of governmental intervention. Such a depoliticisation of trade between nations is also in a position to protect governments from being influenced by such pressure groups whose industries may well have already missed the boat of economic readjustment⁷.

These welfare effects, which are possible in theory, only then gain empirical relevance if the General Agreement on Tariffs and Trade is in fact adhered to in all its basic principles. In order to assess the actual effects, it is therefore essential to analyse the extent to which the regulations and mechanisms of GATT have stood up to the strains of trade policy over the years.

⁶ On the problem of uncertainty and investments cf. Richard Blackhurst, Nicolas Marian, Jan Tumir: Adjustment, Trade, and Growth in Developed and Developing Countries, GATT Studies in International Trade No. 6, Geneva 1978, p. 45 f.

⁷ In this context, Giersch sees GATT as a cartel of governments, a protective measure against pressure groups. Cf. Herbert Giersch: A European Look at the World Economy, Kieler Sonderdrucke No. 60, p. 13 (Reprint of: The Twelfth Annual William K. McNally Memorial Lecture, University of Michigan, Ann Arbor 1978.)

Generally speaking, it can be confirmed that the GATT regulations have not always been upheld to their full extent. The flow of goods and services grew in real terms by an approximate annual average of 7 % between 1948 and 1980; alongside GATT, the most important determinant factors for this intensification of the international division of labour were the liberalisation of the international flow of capital, technological progress, the improvements made in transport and communications, etc. This long-term average increase, however, does not reveal the differing stages of development. Adjusted for inflation, world exports following the completion of the reconstruction phase of international economic relations averaged an annual increase of 8.5 % between 1963 and 1973, 4 % between 1973 and 1980, and only 1.5 % in 1980. There is also a parallel decline in the growth rates of world production. A real increase of 6 % p. a. between 1963 and 1973 was followed by an annual growth rate of 3 % between 1973 and 1980, and a real increase of only 1 % in 1980⁸. This demonstrates how closely the development of world trade and of world product are in fact linked⁹.

The drop in the growth rates of world trade and world production cannot be explained solely by referring to the two oil shocks of 1973 and 1979. This development was also determined by a number of monetary, cyclical, structural and political factors. If our attention is focussed on GATT as a determinant factor, it can be seen that the contractual fidelity of the member countries was relatively large up until the end of the 60s¹⁰. In addition, the contracting parties were willing to further liberalise world trade. This found its expression in six rounds of tariff negotiations, which led to an – in some cases considerable – easing of the international flow of goods and services. The preconditions for long-

term entrepreneurial investments were therefore fulfilled, both in theory and in practice, and the growth rates in real terms of the world product and of foreign trade bear witness to this. This period is thus regarded as the most successful for GATT.

Following the mid-60s, however, there has been an increasing deviation by contracting parties from the rules of GATT. Together with a growing politicisation of world trade, there is also a trend towards the erosion of the most-favoured-nation principle. Both trends seem to be on the increase. They pose a threat to the GATT system and gradually undermine its basis for creating welfare gains.

Growing Politicisation of World Trade

One of the reasons behind the increasing politicisation of world trade over the past 10 to 15 years has been the growth of activities by pressure groups. Feeling the effects of foreign competition, they demand that certain branches be protected against foreign suppliers by governmental measures. They are able to support their arguments by referring to the possible loss of jobs, which tends to evoke a response by any government.

Although GATT's intention was for governments to keep out of international trade as much as possible, Keynesianism provided the intellectual justification for overall control of economic processes and interventionist activities in foreign trade¹¹. Many industrialised countries, including West Germany, subscribed in the 60s to Keynesian economic policy. Under the political pressure of the various lobbies to protect domestic industries, and supported by Keynesian theories, many governments saw themselves forced more and more into having to tackle problems of employment and structural problems. The GATT agreements, however, made it impossible to tackle domestic difficulties by resorting to tariff increases or by introducing import quotas. Under these

⁸ Cf. GATT: International Trade 1980/81, Tab. 1.

⁹ This link can also be confirmed for other periods in the 19th and 20th centuries, cf. Richard Blackhurst et al., op. cit., p. 5 f.

¹⁰ Cf. e.g. the run-down on the arbitration of disputes in Robert E. Hudec's article: GATT or GABB? The Future Design of the General Agreement on Tariffs and Trade, in: The Yale Law Journal, Vol. 80 (1971), pp. 1299-1386, esp. p. 1380 ff.

¹¹ For details on the philosophical basis for government activities cf. Jan Tumir: National Interest and International Order, International Issues No. 4, Trade Policy Research Centre, London 1978, p. 4 ff.

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circumstances, subsidies appeared to be the instrument of economic policy most promising for solving the conflict between the pressures of the domestic economy and the international contractual obligations. Whereas subsidies up to this time were regarded in international economic theory as transfer payments to firms with the aim of alleviating the adjustment of the domestic economy to the realities of foreign trade and thus preventing protectionism, they had now themselves become an *instrument* of protectionism¹². A classic example is the international steel market. No longer are the steel-producing firms the primary competitors, but rathermore the individual government treasuries.

This development confirms that the basic consensus in GATT concerning government activities no longer applies to *certain parts* of the international market. This puts a check on entrepreneurial initiative and means that one of GATT's primary objectives, to bring about welfare gains by means of an international system for regulating competition, has been partially abandoned by the contracting parties. Although such measures, taken individually, may not affect the Agreement as such, precedents are created which could be taken as an example and copied, thus undermining the GATT system.

Most-Favoured-Nation Principle Eroded

Alongside the growing politicisation of world trade, another not less dangerous threat exists to the trade system. The penetration of the international textile market by developing countries confronted the industrialised countries with their first taste of the problem presented by so-called low-price supplies. These imports could not be prevented by resorting to the anti-dumping measures contained in GATT, since the behaviour of the developing countries does not conform to the definition of "dumping". Behaviour according to the spirit of the GATT system would have necessitated readjusting the domestic economy in the form of cut-backs in the textile and clothing industries in the industrialised countries. However, yet again the rules agreed upon were not upheld. Instead of regarding this as an opportunity to put the principle of dynamic comparative advantages into practice, the Cotton Textiles Arrangement was drawn up in 1961, which has since been extended up until July 31, 1986, under the name of the Multi-Fibre Arrangement¹³. This agreement provides for *bilateral* negotiations between importers of textiles and the respective exporting countries over "voluntary" export restrictions. Contrary to the explicit ban on quantitative import restrictions within the

framework of GATT and also contrary to the most-favoured-nation principle, this agreement implies a bilateral fixing of import quotas and their growth rates. There is a certain amount of irony in the fact that under the auspices of GATT and without resort to any of the envisaged provisions for exceptions, protectionist measures are to a certain extent institutionalised and bilateralism is placed under multilateral control. This rejection of the most-favoured-nation principle represents not only an impairment of competition, but subjects each developing country involved to the negotiating powers of an industrialised nation.

The tariff preferences for developing countries represent a further deviation from the most-favoured-nation clause. They have been granted since 1971 – at first with reference to a "waiver" in GATT; ever since their legalisation within the Tokyo Round they have become an integral part of the Agreement. However, there is no longer a general regulation, but *eleven different* preference systems¹⁴. The actual form they take differs considerably. However, the strong orientation towards the economic interests of the countries involved is a common feature. This is particularly the case for the industrialised countries. In their most important preference systems, those of the USA, the EC, and Japan, the individual goods are classified according to their degree of sensitivity. The more sensitive a product, the less the tariff preferences conceded, which means that the very sensitive goods receive no special tariff treatment whatsoever. In addition, maximum import quotas for which duty can be paid at a preferential tariff are set for each individual developing country interested. An inverse allocation of quotas can be observed: those countries with a greater competitive ability can fulfil their quotas relatively fast, whereas the weaker countries come nowhere near exhausting their quotas. So as to prevent goods from the more competitive countries being diverted via the weaker countries, certificates of origin are demanded, which leads to additional costs for exports and for controls in the importing country. The EC is no exception to such activities. With quotas for developing countries being separately allocated for each EC member country

¹² For a general analysis of this problem cf. Sidney Colt: Beyond the Tokyo Round, in: *The Banker*, August 1979, pp. 45-50, esp. p. 47 f.

¹³ Cf. Henryk Kierzkowski, Gary Sampson: The Multi-Fibre Arrangement, the approach and setting to the forthcoming negotiations, in: *Außenwirtschaft*, Vol. 36 (1981) pp. 41-56, esp. p. 50 f. Cf. also Gerard and Victoria Curzon: The Undermining of the World Trade Order, in: *ORDO*, Vol. 30 (1979), pp. 383-407, esp. p. 384 ff.

¹⁴ Cf. Bettina Hüni: Die bestehenden Systeme von Präferenzzöllen zugunsten von Entwicklungsländern (The Existing Systems of Preferential Tariffs for Developing Countries), in: *Außenwirtschaft*, Vol. 30 (1975), pp. 115-132.

and not for the Community as a whole, certificates of origin, e. g. in the case of textiles, are being demanded within the European Community despite its common foreign trade policy.

This confusing maze of different preference systems very often makes it difficult for exporters to find out whether they have already fulfilled their quota or not. This means that even more costs are created for trade. There is also doubt as to whether the preference agreements are unreservedly advantageous to the developing countries. Furthermore, the fact that individual goods, for which developing countries are particularly competitive, can be exempted completely from preferential treatment, leads to the suspicion that, via preferences, certain other branches in industrialised countries are to be protected. One would therefore expect a general most-favoured-nation approach for *all* goods to be better for developing countries as a whole than specific preference rulings.

Danger of Escalation

Arrangements such as the Multi-Fibre-Arrangement and the preferential agreements have set precedents for further bilateral agreements both between industrialised countries and between industrialised and developing countries. Similar agreements have already been reached for international trade in steel, motor vehicles, ceramics, shoes, ships, consumer goods from the electronics industry, etc¹⁵. On these markets the international mechanism of competition has been partially abandoned and, contrary to the original GATT idea, the more able supplier is forced to carry a large part of the costs of readjustment. This means that GATT has to a certain extent lost its character as a norm-setter. A trend towards further special arrangements, without making use of the safeguards envisaged in GATT, cannot be ruled out. Such bilateral consultations, which were originally intended to help remove illegally erected trade barriers, now appear to have the function of trying to gain understanding for disruptions of international trade or of exchanging mutual protectionist concessions.

If the two contracting parties involved are in agreement, they both have the impression that their action is legitimate, and not that it is contrary to GATT principles. This implies that the legal attitude of the

contracting parties has changed, which is reflected in the weakening of the most-favoured-nation clause. The results are transaction costs in the form of costs for information, negotiation and control, which are precisely those which the principle of non-discrimination was intended to reduce. In addition, the bilateral agreements have, due to their selective character, become *part of an international discrimination* of individual suppliers, i. e. an instrument of protectionism. This means that the costs of protectionism, which have frequently been analysed by economists, additionally arise especially in the form of losses of efficiency. Each of these individual arrangements may well be rational in the short run and help solve an immediate crisis. However, if they take on a permanent character, and if infringements of the fundamental principles of GATT are continually legitimised informally or via formal integration in the Agreement, this will inevitably lead to a gradual weakening and destruction of the system.

The change in the legal attitude of governments has already induced greater uncertainty amongst entrepreneurs. It is bound to adversely affect their willingness to carry out *long-term* investments, which would be effective for employment and growth. This would affect not only the GATT system but also the national economies. For this reason, the uncertainties in trade policy as to whether governments will set up bilateral arrangements without warning or not, must be eliminated before an escalation comes about. No one government, however, is basically protectionism oriented¹⁶. This would imply that the stabilising factor of this system, the mutual fear of a repeat of the situation regarding trade of the 30s, is strong enough. The best stabiliser of any system, however, is not the fear of its disintegration, but its success. The advantages of the GATT system cannot be enjoyed in full by means of ever new special agreements for individual markets, but through a strengthening of its basic principles. It would therefore be advisable to again enhance the importance of the most-favoured-nation clause and at the same time make the safeguard provisions more effective. This would push back the bilateral arrangements, such as the preferential agreements and the self-restraint agreements, which are expensive in all respects. In addition, governmental practice regarding subsidies should be made more transparent, for example, by means of subsidy reports¹⁷. Negotiations, similar to those for tariffs, could then be carried out with regard to the reduction of subsidies, thus giving added impetus to liberalisation. For, in the long run, a piecemeal trade policy, which is geared to immediate everyday problems, is of no use to anyone.

¹⁵ Cf. Bahram Nowzad: The Rise in Protectionism, IMF Pamphlet Series No. 24, Washington D.C. 1978, p. 10 ff.

¹⁶ Cf. GATT: International Trade 1980/81, p. 11.

¹⁷ On the question of safeguards and the suggested subsidies reports cf. Bela Balassa: The "New Protectionism" and the International Economy, in: Journal of World Trade Law, Vol. 12 (1978), pp. 409-436.