Subsidies and trade barriers

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The challenge

Eliminating government subsidies and trade barriers has clear economic benefits. Despite evidence that those policies harm the economies which impose them and are particularly harmful to the world's poor, governments continue to intervene in markets for both goods and services. This chapter argues that phasing out these trade-distorting policies should be the highest priority among the opportunities assessed. Not only would this strategy have a direct effect on poverty reduction, but there would also be indirect benefits across the full range of CC challenges. Moreover, the relatively small costs of adjustment to reform would leave plenty of the notional $50 billion to be spent on second priorities.

The most recent big surge of protectionism was about75 years ago. Following the Second World War. governments of major industrial countries – well aware of the economic rationale for free trade – sought ways to reduce import tariffs., But politicians fear making changes that may be associated with politically unpopular redistributions of jobs, income and wealth. The challenge therefore involves finding politically attractive ways to phase out the remaining distortions in world markets for goods, services, capital and potentially even labour.

The arguments for and against removing subsidies and trade barriers

Free trade is often criticised by non-economists on the assumption that it has negative social and environmental consequences, as evidenced by the burgeoning "anti-globalisation" movements. But these need to be weighed against various positive social and environmental consequences as well as the net economic benefits – both static and dynamic - of meeting the challenge.

Static gains arise from countries producing more of the goods and services they can provide most efficiently and less of what others can produce more efficiently. Each country will maximize the value of its output of goods or services and these will be sought by trading partners because they are competitively priced. After trading, each individual country will be better off than in a world without trade. This is commonly referred to as the principle of comparative advantage. The smaller the economy, the greater the static gains from trade tend to be as a share of national output.

Additionally, *dynamic* gains result as increased trade fuels economic growth. Typically, freeing up imports of intermediates and capital goods encourages entrepreneurs to make greater investments in production capacity. Evidence gathered during the second half of the twentieth century shows that countries which have liberalised their trade have enjoyed an average 1.5% increase in annual GDP growth compared with the pre-reform rate. Of course, governments also need to do other things right to attract investment, such as protecting property rights and maintaining financial and political stability. Free trade is a necessary but not sufficient condition for sustained economic growth.

Despite the potential gains from trade, most governments retain at least some protectionist policies. The reason is political. Although the total wealth of an economy increases when trade is liberalised, owners of capital and workers in the most-protected industries may lose, and any compensation typically covers only a small fraction of those losses. The losses are concentrated in the hands of relatively few people who are prepared to lobby the government and support protection-minded politicians, whereas the benefits are spread widely across industries and the general population such that the recipientsface a free-rider problem in getting together to lobby for reform.

Governments are also influenced by the arguments of NGOs who claim globalisation is adding to social and environmental problems in both rich and poor countries, despite evidence to the contrary.

There are, however, a number of ways in which trade reform can be fostered or initiated, including:

- Better dissemination of the case for free trade by governments, think tanks and those directly involved in import and export, to counter lobbying by NGOs, trade unions and other special-interest groups;
- Technological changes – for example, the revolution in information and communications in the last two decades – which can dramatically lower the costs of doing business internationally;
- Unilateral liberalisation by other countries, which can highlight the benefits of open markets; and
- Opportunities to join international trade agreements, which can provide more politically acceptable alternatives to unilateral liberalisation (although bilateral and regional deals have less potential to add to national and global welfare than broader multilateral trade agreements)..

The opportunities

There are four opportunities considered here:

- **Opportunity 1** is to move to a world free from subsidies and trade barriers: free trade in its purest form. Although this seems politically unlikely at present, it gives a benchmark against which other options can be measured.
- **Opportunity 2** is to successfully complete the current round of WTO negotiations: the Doha development agenda. This would involve a global legally binding partial trade liberalisation, with all participants on an equal footing as WTO members account for more than 95 per cent of global trade. Success is far from assured, however, and the timeline for its completion is likely to extend significantly beyond the current deadline of the end of 2004 unless extraordinary efforts are made by the major players.
- **Opportunity 3** comprises a range of more limited, but nonetheless important, regional trade agreements, for example via the Asia Pacific Economic Cooperation (APEC) forum or European Union (EU) enlargement. The APEC agreement is non-binding but also non-preferential – it gives market access to all trading partners of each signatory (a so-called 'Most Favoured Nation' or MFN reform) and is thus effectively a sub-set of WTO reforms. EU expansion is an example of a reciprocal preferential agreement: all participants have access to

each other's markets, but their external trading partners are excluded from the deal. Following the EU's expansion eastward in May 2004, the most ambitious reciprocal preferential agreement in prospect is the proposed Free Trade Area of the Americas (FTAA), which would bring together all the economies of North, Central and South America, so it is this agreement which is considered here.

- **Opportunity 4** covers agreements that enable preferential market access for exports from developing countries to rich economies: so called non-reciprocal preferential trade agreements. EU countries have allowed imports from former colonies on this basis in the past, but the EU proposal to provide duty- and quota-free access for all least-developed countries is being embraced by numerous advanced industrial economies.

Benefits and costs of reducing subsidies and trade barriers

Economic benefits

Most published studies reviewed in this chapter employ computer simulation models of the global economy of the computable general equilibrium (CGE) type. These have increasingly been used for analysis of multilateral trade reform since their introduction in the late 1970s. Although by no means perfect (after all, they are only models), they capture the economy-wide nature of adjustments and yet include sufficient detail of industrial sectors to be useful to a wide range of parties.

These models have been used by trade economists most commonly to analyse the effects of reducing trade barriers and agricultural production and export subsidies. Non-agricultural subsidies are not considered because they are not the main focus of WTO negotiations, precise data on them are at best patchy, and in any case agricultural subsidies are estimated to account for some 40% of all government subsidies.

Opportunity 1 – Removing all trade barriers and agricultural subsidies
Relatively few studies have considered this most radical option. The benefits derived vary with assumptions, ranging from $254 billion per year from 2005 (with $108 billion of this accruing to developing countries) to $2080 billion (with $431 billion to developing countries). The higher figure assumes also liberalisation of services, including foreign direct investment. Three other studies give benefit figures falling between these two extremes.

All of the studies show agriculture to be the main contributor to gains, accounting for 65-70% of the total. This reflects the high degree of protection from farm imports in nearly all countries (both rich and poor) and the direct government support of farming in some rich countries.

None of the studies examine the effect of freeing completely the international movement of labour. However, it was recently estimated that even a modest relaxation – allowing temporary immigration to increase industrialised country labour forces by just 3% (which would involve 16.4 million workers from developing countries)– would increase global income by $156 billion. Most of the benefit would accrue to the developing country migrants.

Opportunity 2 – Reducing trade barriers and agricultural subsidies in the WTO's Doha round

This so-called "development" round of trade negotiations, which started in November 2001, has made little progress to date. We can nonetheless consider the potential benefits.

An optimistic assumption of 50% across-the-board cuts to bound tariffs and farm subsidies leads to predicted benefits of approximately half those to be derived from full liberalisation – around $200 to $1000 billion a year – although with a different balance of beneficiaries. No allowance has been made in those estimates for reform-stimulated economic growth or for the effect of liberalising labour or capital markets. If these were included, the benefit could be much higher.

Opportunity 3 – Removing intra-American trade barriers following the FTAA negotiations

The creation of regional Free Trade Areas (FTAs) – even one as large as the proposed Free Trade Area of the Americas (FTAA) – has limited benefits. The gains would be a small fraction of those to be derived from a significant liberalisation of world trade via the WTO. No doubt some individual developing countries would benefit, but no more so than if global trade barriers were modestly reduced.

There is also a downside to such areas: some countries benefit by being in the FTA, but this can be at the expense of excluded economies. The net global effect could even be negative, with greater losses from trade diversions from excluded countries than gains by FTA members. Nevertheless, agreements of this type continue to be pursued, not least because they can be brought about faster and with less political difficulty than multilateral changes via the WTO.

Opportunity 4 – Removing developed country barriers to exports from least-developed countries

An example of this approach is the EU's proposal to extend to United Nations-designated "least developed countries" (LDCs) duty- and quota-free access for exports of "everything but arms" (EBA). This may sound like a good idea, but it does not include trade in services, particularly the right for LDC workers to obtain temporary work permits, and has a number of other drawbacks.

Necessarily this initiative is tiny in terms of global impact, because LDCs are such a small part of the global economy Certainly it could have significant benefits for some people in sub-Saharan Africa (SSA), where exports could increase by perhaps $0.5 billion a year, according to World Bank estimates. A wider World Bank study suggests that LDCs across the world could benefit by up to $2.5 billion if they had unfettered access for their exports to the EU, the USA, Canada and Japan. However, this would be partly at the expense of other not necessarily poorer developing countries. Also, it would give LDCs little incentive to reduce their own internal and external barriers to trade, and would eliminate their incentive to push for global trade liberalisation at the WTO.

How can progress best be made by 2010?

If progress is to be made in the face of strong protectionist pressure from powerful domestic interest groups, a multi-pronged approach must be adopted. This would encourage both unilateral reform within countries and comprehensive multilateral reform through the WTO, supplemented by regional initiatives of the sort which support both. To counter the entrenched protectionist forces whose lobbying of national governments is extremely influential, the case for free trade needs to be made more strongly, for example by sponsoring policy think tanks and others able to effectively disseminate to the gainers from trade reform the empirical findings of researchers.

Preferential trade agreements seem destined to be part of the ongoing move towards liberalisation, although on their own they are not the best solution. Non-reciprocal agreements (opportunity 4) in particular are of doubtful value, discouraging further liberalisation and disadvantaging non-LDC developing countries (which include such poor countries as Vietnam). Free Trade Areas have similar drawbacks, and deliver only a fraction of the benefits realisable from WTO-based multilateral reform.

Summary of gross benefits

As a working figure, an average of the upper and lower bounds of studies used as a basis for this chapter has been taken: this amounts to a 1.8% increase in global GDP as the static gain (i.e., taking no account of reform-stimulated economic growth) after full adjustment to the new regime. For developing countries, the benefits would be relatively higher: 2.5% of GDP. It is assumed that the gains will begin at one-fifth of that rate but rise by one-fifth each year from 2006 until 2010 when they are assumed to be fully realised.

In addition, there are dynamic gains from free trade. A conservative estimate is that reform would boost the annual rate of economic growth by one-sixth for developed countries and one-third for developing countries. For the world as a whole, growth would rise from 3.2% to 3.8% a year, while for developing countries this would raise their average annual growth rate from 4.6% to 6.1%.To again err on the conservative side, this higher rate of growth is assumed to continue just until 2050 rather than forever.

Economic costs

The costs incurred in the reform process are one-off, in contrast to the gains which are long-term and continuing. Costs include those associated with negotiation rounds, support for policy think tanks, adjustments for companies and workers and social costs and welfare payemnts for the temporarily unemployed. Studies tend to show that such costs are relatively small compared to the gains, and are minimised by careful phasing-in of reforms. However, governments may still be reluctant to reform, since job losses tend to be concentrated and highly visible, whereas the gains are spread so thinly across the entire economy as to not be obvious to most citizens.

For the purposes of this chapter, it is assumed that the adjustment period following 50% liberalisation lasts for 5 years (considerably longer than has been found in most case studies). For each year, the cost is assumed to be one-third of the eventual total static benefit of the reform: $243 billion annually for the period 2006-2010, with $71 billion of that incurred in developing countries.

Social and environmental benefits

By generating large economic gains over a long period, trade reform would indirectly help to tackle the other global challenges by making more funds available. However, there would also be direct effects on a number of key challenges. For example:

- *Poverty reduction* would be fostered as faster-growing developing economies have been shown to be better at reducing poverty than countries with slow economic growth;
- *Communicable diseases* could be tackled more effectively by countries where poverty is reduced and medicines are more widely available and affordable;
- *Conflicts* are likely to be reduced when countries are more economically interdependent and where there are fewer barriers to migration; and
- *Educational under-investment* particularly by poor families in developing countries is likely to be alleviated by trade reform-induced increases in international prices for farm and textile products.

Global benefit/cost ratios

Lower-bound estimates for the overall net benefits of halving subsidies and trade barriers indicate an approximate doubling of annual GDP growth after the initial (assumed 5-year) adjustment period. Assuming there were no further benefits after 2050 (though this is unlikely) and using a discount rate of 5%, the net present value would be $23 trillion for the world economy, with half of this accruing to the current developing economies. Given the present value of estimated adjustment etc. cost of just under $1 trillion, the benefit/cost ratio is 24.3 globally, and 37.9 for the developing countries.

If social and environmental benefits and costs were included, these figures would most likely be considerably higher. Even if more conservative assumptions are made about the success of the Doha round and the transition period, benefits are still likely to be enormous and the costs easily justifiable. All this is within our grasp, given bold leadership and a willingness to make the most of the opportunity available for unilateral and multilateral trade reform, particularly within the WTO framework.