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SUBSIDIES AND TRADE BARRIERS
PERSPECTIVE PAPER

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Subsidies and Trade Barriers

by

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ABSTRACT

Perspectives on Reducing Subsidies and Barriers to International Trade and Migration

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Perspectives on Reducing Subsidies and Barriers to International Trade and Migration

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I. Introduction

Kym Anderson and Alan Winters, in their Challenge Paper on trade and migration, have done a fine job of marshalling the evidence on the net benefits of liberalization. Their message is the familiar one that developing countries especially stand to gain from further liberalization of barriers to trade and migration, and therefore that such liberalization should play a central role in any list of initiatives to address the challenges posed by the current round of the Copenhagen Consensus. Like most if not all economists who deal with these issues in their research and teaching, I agree with their conclusion. I also agree that the studies they cite in their paper provide the best evidence that we have of what the costs and benefits of this liberalization might be.

To put their arguments and findings in perspective, therefore, I will make just a few points. First, their use of a benefit-cost ratio as a means of quantifying the desirability of liberalization is misleading, if not inappropriate, especially given the use of CGE models for that purpose. Second, I would prefer that they not look just at the net economic benefits from liberalization and compare them to costs associated with implementation. Rather, it would be preference to quantity both the gross economic benefits and gross economic costs separately, and in particular to give more attention than they do to the gross costs.

Finally, I will note that the real challenge with regard to trade and migration is not to know what to do, but rather to find a way to do it. Recent experience with the Doha Round of trade negotiations as well as with efforts, in the United States at least, to liberalize migration has been depressingly unsuccessful. I will conclude with some very tentative thoughts about how the world might move forward in the direction that the Challenge paper shows convincingly is desirable.

II. Pros and Cons of Benefit-Cost Ratios

A few years ago I was asked by the dean of my school to teach our course in benefit-cost analysis. I objected that I knew nothing about this subject and was told that of course I did, as I had been practicing benefit-cost analysis for most of my career in my work on tariffs and other international trade barriers. Sure enough, when I read the textbook that my dean, Ned Gramlich, had himself written (Gramlich 1990), I found much of it very familiar. However, there was one point that would have been unfamiliar to me, had it been included in his text: the use of benefit-cost ratios as a criterion for selecting policies. In fact, this tool was mentioned by Gramlich only to dismiss it as misleading. Better, he said, to use the net benefits of a policy or project – that is, total benefits minus total costs – as a guide to choosing among alternatives, since that will yield the maximum improvement in social welfare, whereas the choice with the highest benefit-cost ratio might not, if costs of various choices differ.[1]

As I recall reading about the first Copenhagen Consensus, the exercise was to consider alternative ways of spending a fixed sum of resources, and in that context the use of a benefit-cost ratio versus a measure of net benefit from that given cost are equivalent. But in general, if the costs of alternatives are not the same, then the choice of one with the largest benefit-cost ratio may be far from optimal.

Of course, a benefit-cost ratio of less than one is very meaningful, since it indicates that the net benefit from the choice is negative. Thus calculating benefit-cost ratios in order to check that they exceed one is worth doing in many contexts. However, in the context of trade policy, the models that we use effectively guarantee that, at least for the world as a whole, benefit-cost ratios will be larger than one. That is the message of the large theoretical literature on the gains from trade, which show that under certain assumptions aggregate economic welfare of the world as a whole is increased by reducing trade barriers to zero. The same is true for individual countries except for the possibility of terms-of-trade effects that may in addition divert welfare from some countries to others. The assumptions under which the gains from trade exist are routinely made in the computable general equilibrium (CGE) models that Anderson and Winters cite. Therefore the positive net benefits from moving to free trade, and thus the result that benefit-cost ratios exceed one, are true by assumption.

Still, one might argue, one need not have expected these ratios to be as large as Anderson and Winters find them to be. In their Table 11, they report benefit-cost ratios from complete trade liberalization ranging from a low of 17 to a high of 3147. This means that the benefits from liberalization are at least seventeen times their costs, and probably much, much higher. Surely that is a strong indication not only that liberalization is beneficial but that the costs of liberalization are negligible.

In fact, however, the costs that are included in the denominator of this benefit-cost ratio are far from being the total costs imposed by liberalization. Anderson and Winters treat as costs only the costs that are, as they note, ignored in CGE models: administrative costs of changing policies, adjustment costs of firms and workers moving from one equilibrium to another, and social costs of programs to assist those displaced by liberalization. These, they note, are small compared to the net benefits that the CGE models do quantify as arising from liberalization, largely because they are transitory while the net economic gains persist over time.

But these net benefits are themselves a difference between benefits and costs, the latter being the fall in wages and returns to specific assets (including both physical and

[1] See Gramlich (1990, p. 42).

human capital) in import-competing industries. As is familiar from partial equilibrium analysis of tariffs, trade liberalization creates a net benefit that is the difference between a much larger benefit to buyers of an imported product and a loss, often substantial, to domestic sellers. How these losses appear in a CGE model depends on its structure, perhaps being a fall in returns to specific factors or perhaps being a fall in the wage of the country's scarce factor. But either way, they are costs that, if they were included together with their matching benefits in both the denominator and the numerator of the benefit-cost ratio, would make that ratio much smaller.

To illustrate, see Figure 1, which shows the very standard partial equilibrium analysis of a specific tariff, t=\$4, on supply, demand, and welfare of a small country facing a world price P^W=\$8 for a good that it imports. With the tariff, the domestic price is the world price plus the tariff, \$12, domestic supply is 100 units, domestic demand is 170 units, and therefore the country imports 70 units generating a tariff revenue of \$280. When the tariff is removed, domestic price falls to the world price, \$8, quantity supplied falls to 60, quantity demanded rises to 190, and imports increase to 130 units. This equilibrium analysis does not tell us the costs of implementing the tariff cut, such as administrative cost or costs of suppliers moving into another industry. It does however tell us the net economic gain from the tariff cut, which is the "dead weight loss" due to the tariff and is measured in the figure by the areas of the two triangles *b* and *d*. Together, this dead weight loss is \$120. Suppose that the implementation costs are as small as Anderson and Winters find them to be, say \$2. Then the benefit-cost ratio is 60.

But the economic losses caused by the tariff include much more than these implementation costs, and indeed the gross economic gain is much larger than this foregone dead weight loss. Demanders of this good gain the change in consumer surplus, which is the full area to the left of the demand curve between the two prices, and thus \$4×180 = \$720. At the same time, suppliers lose producer surplus equal to \$4×80 = \$320 and the government loses the entire tariff revenue, \$280. If we include these gains and losses in the calculation of the benefit-cost ratio, then benefits are \$720 while costs are \$2+320+280 = \$602, and the benefit-cost ratio is only 720/602 = 1.2

One might object that the figure shows quite a large tariff (50%), and the tariff revenue is therefore much larger than we usually see, at least in developed countries. But with a little manipulation of the figure you can see that, as the tariff being eliminated becomes smaller, the benefit-cost ratio becomes smaller and closer to one.[2]

III. Gross Benefits and Gross Costs

I would prefer, therefore, that the analysis of liberalization of both trade and migration report separately both the gross benefits and the gross costs that these liberalizations entail. That might not be easy to do, since CGE modelers (including

[2] In Figure 1, for example, if the tariff had been only \$1 instead of \$4, with the same world price and supply and demand curves, the demander benefit of eliminating it would become only \$187.5, the supplier cost of eliminating it would be \$65, and the tariff revenue lost would be \$115. Then even if the implementation cost were now zero, the benefit-cost ratio for tariff elimination would be only \$187.5/\$180 = 1.04.

myself), do not routinely provide this information. They may report changes in wages and returns to capital, which could in principle capture Stolper-Samuelson-driven changes in returns to scarce and abundant factors. But much more relevant would be industry-specific changes in wages, employment, and asset values that impact the lifetime earnings of those who have invested in industry-specific skills and assets.

Anderson and Winters acknowledge these costs but treat them as minor and transitory. They are indeed transitory, but only in the sense that many of those affected will eventually retire and die, being replaced by others who have invested their physical and human capital in other industries. Anderson and Winters mention them primarily to note the ability of those who will bear these costs to resist cuts in protection by political action. But in fact the costs to them as human beings should also be acknowledged in a full analysis of liberalization.

This is especially true in countries where policies do a poor job of providing safety nets for those impacted by economic change. This is perhaps least true in Europe, but it is certainly true in the most developing countries and is arguably true in the United States as well. Our economic arguments in favor of trade liberalization, as embodied in CGE models, are based on the result that the gains from trade are larger than the losses. But advocates of trade liberalization are often criticized for ignoring those losses entirely. I have often defended our discipline by insisting that we certainly do not ignore the losses, and I point to both the Stolper-Samuelson theorem and the specific factors model as part of the evidence in our favor. But quantitative analyses of trade liberalization, as exemplified by this analysis by Anderson and Winters, too easily feed that criticism by giving only minimal attention to those losses.

Anderson and Winters mention these costs primarily in the context of explaining protection. The costs are sufficiently concentrated and identifiable, they say, that "the few losers are prepared to support politicians who resist protection cuts." (p. 24) That may well be true. But one does not need explicit or costly lobbying activities, or politicians "selling" protection as suggested by Grossman and Helpman (1994), for representatives of trade-impacted legislative districts to seek protection for their constituents.[3] On the contrary, many societies and their governments view it as quite appropriate to resist economic harm to significant parts of their populations, even if that means foregoing or delaying aggregate economic gain. Corden (1974) called this the Conservative Social Welfare Function and used it to explain protection without the explanation resorting to manipulating the self interest of politicians.[4]

The human costs of trade liberalization are particularly important when they are borne by the poor in developing countries. Fortunately, that is not always, or perhaps not even often, the case. The benefits from protection in developing countries often accrue to the highest-income urban elites, which is why protection is particularly hard politically to eliminate. But there are also plenty of cases in which the poor stand to lose from freer

[3] See Hall and Deardorff (2006) for an analysis of legislative lobbying that does not involve persuading legislators to support actions that they would not otherwise favor.
[4] See also Deardorff (1987) for use of the Conservative Social Welfare Function to motivate safeguards policies.

trade. In those cases trade liberalization will run counter to poverty reduction unless deliberate steps are taken to prevent that. The example that comes to mind is peasant farmers who grow maize in Mexico, and who were unable to compete with the large mechanized farms of the United States when NAFTA removed their protection. Other examples undoubtedly exist and need to be identified as part of the preparation for any move to liberalize trade. CGE modelers should ideally seek not only to identify those poor who will be displaced by trade, but also to model policy initiatives that might ameliorate the harm that will be done to them. These policy initiatives would certainly include the slow phasing in of tariff reductions and hopefully also other policies such as relocation and retraining programs to assist displaced populations to transition into expanding sectors of the economy.

IV. Subsidies and Migration

I have been talking explicitly about international trade, and about trade policies such as tariffs. The Anderson and Winters paper also deals explicitly and extensively with migration. And the topic of this Challenge includes subsidies, although these get less attention than barriers to trade and migration in the Anderson and Winters paper. The points I have raised here, however, apply as well to migration and subsidies as they do to trade and tariffs.

Benefit cost ratios are no better as a guide to migration policy, or to dealing with subsidies, than they are to trade liberalization. Instead, as Gramlich (1990) stressed and I echo, in both cases one should look at overall net benefits from a policy change, not worry about how large a multiple benefits may be of costs. Just as importantly, however, one needs to acknowledge what the gross costs are, and confront them with additional policies wherever possible.

Anderson and Winters do that implicitly in dealing with migration. In terms of economic effects, it is clear that net benefits are maximized by allowing migration to be, like trade, perfectly free. But they do not for a moment entertain free migration as a candidate for policy. Their choice instead is to model an arbitrary three percent increase in the labor force of developed countries through migration. That is presumably far less than would occur with free migration, for reasons that remain unmodeled.

Subsidies are handled by Anderson and Winters along with trade barriers as just another distortion of international trade, and not a terribly important one at that, except for a few particular industries and countries (e.g., cotton, and the developing country cotton producers). Quantitatively and in terms of net benefits from liberalization, I am prepared to believe that they are right. Subsidies probably do not deserve the attention that they have gotten in the Doha Round negotiations. But if we look, again, at the gross benefits and costs of removing subsidies, which are very different than they are for tariffs, then the attention they are getting and the resistance to removing them may become more understandable.

V. The Real Challenge: Making Liberalization Happen

One might hope that, once the case is made by economists that reducing barriers to international trade and migration will be beneficial for the world, and especially for the poor, the liberalization itself will then happen naturally. But economists have been making this case in various forms for over two centuries. Trade barriers have indeed come down on occasion, especially during the last half of the twentieth century. But it took the institutions of the GATT to bring most of that reduction about, and in recent years further reductions on a multilateral basis have been elusive. Making the economic case for reducing barriers is certainly worth doing, but it will never be enough.

The problem today takes two forms: the impasse that has been reached in the Doha Round of multilateral trade negotiations within the WTO; and the proliferation of preferential trading arrangements (PTAs) outside of the WTO. These two problems are mutually reinforcing, the Doha impasse both prompting, and being prompted by, the PTAs. Together these to problems mean that while trade barriers are still being reduced, they are no longer nondiscriminatory, and it is therefore unclear whether the trading system at large is becoming more or less distorted.

The Doha Round, dubbed the Doha Development Agenda, began in 2001, not long after the events of September 11 focused the world's attention on achieving greater harmony in the world, especially with regard to developing countries. In the years since 2001, however, progress in the negotiations has repeatedly come to a halt. The reason has been the usual reluctance of each negotiating party to give up its own protective policies while continuing to demand such concessions by others. This reluctance is not new, having nearly derailed the Uruguay Round negotiations repeatedly in the 1980s and 90s. However, it seems to make negotiations this time around even more intractable than before for at least two reasons.[5]

One is that the larger developing countries are, for the first time, negotiating in concert under the name of the Group of Twenty.[6] This is a positive development, in that developing countries are finally having a more meaningful voice in the negotiations. But it also means that success of the negotiations requires not just agreement between the United States and the European Union, as in the past, but also between them and the developing countries. The fact that developing countries differ much more from developed countries than the developed countries do among themselves means both that the benefits of further liberalization are arguably larger than in previous rounds but also that agreement on liberalization is even harder to achieve.

A second reason for the impasse, since 2006, is the inability of the United States to play a credible leadership role. President Bush lost control of the U.S. Congress in 2006. Then, in 2007, his Fast Track Authority to bring trade agreements to Congress for approval without amendment expired. Both events undermine the confidence that other negotiating countries have that the United States will be able to deliver on any trade

[5] A third reason is the proliferation of PTAs, which give the participants some of the gains in market access that they might have pursued multilaterally. This reduces their incentive to participate in the multilateral negotiations and to offer meaningful concessions when they do.
[6] Membership has fluctuated and it currently includes 23 developing countries. See the G20 homepage at http://www.g-20.mre.gov.br/.

agreement that it signs. Without the United States leading, or even credibly participating in, the negotiations, there is little reason for other groups of countries to make concessions.

Perhaps anticipating this conundrum, or perhaps contributing to it, the Bush administration has pursued since its inception an agenda of bilateral negotiations with a long list of partners. The European Union, after doing the same in the 1990s abstained from further PTAs for a few years. But the EU is now renewing its push for such agreements even as the U.S. has had to pull back with the expiry of Fast Track.[7] Many other countries, too, have negotiated PTAs, so that today the web of overlapping preferential arrangements – Bhagwati's "spaghetti bowl" – encompasses almost every country in the WTO.

On its face this might suggest that barriers to trade have been substantially reduced well below their most favored nation (MFN) levels negotiated in the Uruguay Round. In terms of simple average tariffs, this is true. However, these preferential tariffs both "create" and "divert" trade, as Viner (1950) taught us years ago, and trade diversion is surely harmful to the countries diverted from, while also being harmful to the country doing the discriminating. Furthermore, these preferential tariff cuts apply only to imported goods that satisfy often very stringent rules of origin. The need to document the history of traded goods for this purpose, and to tailor supply chains so as to conform with these rules, means that distortions of trade have arguably increased rather than decreased.

How, then, can progress toward reducing trade barriers multilaterally be achieved? The only answer that I can see is leadership. That is, somebody in authority has to lead the way. They must lead the way, not out of self interest, because the political forces resisting trade liberalization today are as strong as ever, making it unlikely that a political figure can gain by openly advocating free trade. In the past, the forces of protectionism have sometimes been countered by those who stand to gain by exporting, working quietly in the background since their interests are often identified with corporations who are unlikely to excite public sympathy. But export interest no longer seem to be playing as vigorous a role as they once did, perhaps because the most bothersome trade barriers from their perspective have already been eliminated, or perhaps because they stand to gain almost as much from PTAs as from multilateral free trade.

Therefore, we must hope for a leader who will push for liberalization simply because it is the right thing to do. To be able to accomplish anything, that leader must probably come from a country or group of countries that is large and rich, presumably the United States or the European Union. But those economic powerhouses actually stand to gain only a little from further liberalization, since their own markets are already quite open and they have already gained preferential access to many markets elsewhere. Therefore, while economic analysis such as that in Anderson and Winters can show that liberalization is the right thing to do from the perspective of their own aggregate

[7] See Evenett (2007).

constituencies, the political resistance by those who stand to lose (the gross economic costs, again) will make this hard to sell.

Rather, what we need are leaders who are willing and able to make the moral case for liberalization as an essential piece of helping the poor in developing countries. The case for free trade to help ourselves is no longer compelling in rich countries, if it ever was, even though in the aggregate it is valid. But the case for free trade to help the poor around the world could, I believe, be made much more convincingly to the public than it now is.

Globalization has had many effects, some positive and some negative. One that should be taken advantage of is that people today are much more aware than they once were of how others around the world are able to live. Poverty abroad is seen regularly on the media, along with the violence that so often accompanies it. In addition, if alleviating poverty is not a worthy enough goal for its own sake, the spill of both poverty-induced violence and poverty-induced disease across borders has become much more visible also in recent years. Together, the public in the rich world may be better placed than ever before to understand the need to take steps, and even to bear some cost, to solve these problems. If leaders could understand and talk about the importance of trade liberalization for poverty alleviation abroad, then I believe that much of the public in the rich world would be eager to help.

That, of course, is where the Copenhagen Consensus comes in. There are many problems that need to be solved for the good of humanity at large, not for the self interested benefit of individual countries. Trade liberalization is only one tool for solving these problems, but it is one that has been touted as a tool to benefit ourselves. It is indeed that, in the aggregate. But we may be more successful, as well as more honest, if we sell it as a tool to help others.

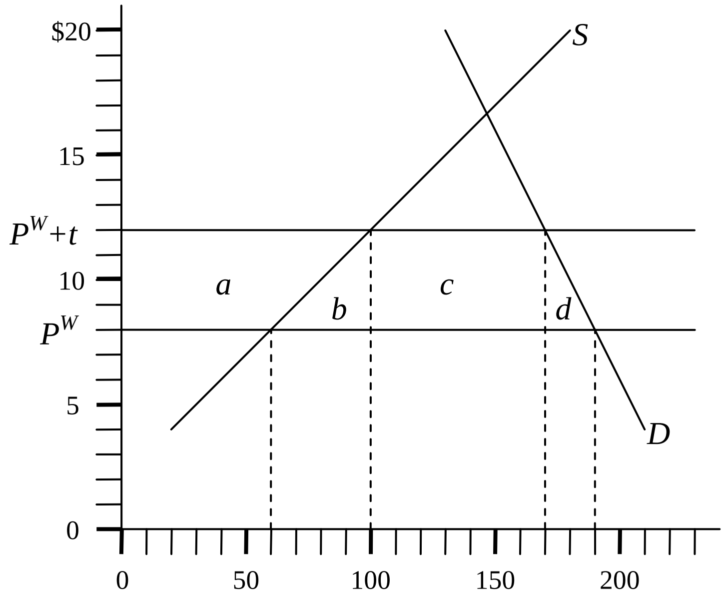

Figure 1: Economic Effects of a Tariff

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