Non-Tariff Measures, New Varieties, and the Role of Trade Agreements

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Domestic Policies in Trade Agreements

- Two different approaches to domestic policies in trade agreements
- Deep integration = direct negotiations over domestic policies
  - e.g. Limits on subsidies in the WTO, competition policy coordination
  - Problems: costly contracting, national sovereignty concerns
- Shallow integration = no direct negotiations over domestic policies
  - Sufficient to contract over expectations of market access
  - e.g. Article XXIII of the GATT
    - Countries negotiate tariff reductions
    - One cannot alter domestic policies to undermine export expectations
- Question: conventional theory says GATT shallow integration should work well, so why do we ever have deep integration?

MARIE CURIE ACTIONS

Domestic Policies and Trade Agreement Problems

- Trade agreements purpose = manage *cross-border policy externalities*
- Often *terms-of-trade externality* = only source of inefficiency
  - Countries seek to improve relative world prices of their products
- Even if imperfect competition externalities exist (e.g profit-shifting), they may not persist if terms-of-trade problem is solved
- If terms-of-trade manipulation is only relevant problem, then GATT shallow integration works well (Bagwell & Staiger 2001)
- Approach: find other policy externalities to explain deep integration

This Paper

- A simple domestic policy determines entry in a differentiated sector
- Cross-border externalities arising from imperfect competition create problems for trade agreements that motivate deep integration
- Theory can match historical evolution of deep integration
  - Focus: restrictions on manufacturing subsidies
- Contrast with prior work (Bagwell & Staiger, Antras & Staiger)
  - Policy choices affect intensive margin of trade
  - Imperfect competition irrelevant for trade agreement design
  - Cannot explain evolution of deep integration

Model

- Build on a model from Helpman & Krugman (1989)
- Two symmetric countries, home and foreign
- Two sectors
  - Monopolistically competitive sector
  - Quasilinear freely traded outside good
- Two factors
  - Specific factor for entry in differentiated sector
  - Mobile labor factor between two sectors
- Government objectives
  - Weight 1 on consumer welfare
  - Weight α on specific factor rents

Production: Firm Entry

- Countries have endowment K of specific factor required for entry
- Governments can hire labor e and e^* to reduce capital requirement
  - Financed through nondistortionary taxation
- Capital requirement: $k(e)$, $k'(e) < 0$
- Number of firms

$$n_h = \frac{K}{k(e)} \qquad n_f = \frac{K}{k(e^*)}$$

Illustration of Failure of GATT Rules

- Suppose
  - Home and foreign negotiate some tariff reductions
  - Foreign unexpectedly raises its entry subsidy
    - No effect on terms of trade, but lowers home sales
  - Foreign lowers its import tariff to avoid GATT complaint from home
- Is everything okay? Maybe not
  - We're in an intra-industry trade environment
  - Home is still affected by foreign subsidy in its domestic market

Foreign Entry Subsidy Effects

- We decompose and sign effects of foreign entry on home

1. Domestic profits decrease (-)
2. Export profits decrease (-)
3. Import tariff revenue increases (+)
4. Consumer surplus increases (+)

Do GATT Rules Alleviate Subsidy Externalities?

- Market access constraints eliminate **some** subsidy externalities
- Consider the combined *effects on home* of the following *foreign policy changes* along the market access constraint
  - a small increase in foreign's entry subsidy
  - a small decrease in foreign's import tariff

1. Domestic profits (-)
2. Consumer surplus (+)
3. Import tariff revenue (+)
4. **Export profits (0)**

- Contrast: market access constraints eliminate **all** subsidy externalities in Bagwell & Staiger (2001)

Difference from Prior Work

- Prior work has failed to rationalize WTO subsidy rules, even if countries have strong political motives
- Results contrasts from two-good P.C. model (B&S 2006)
  - Domestic profit & consumer surplus exist, determined by terms of trade
  - By assumption, countries benefit from terms-of-trade improvement holding local prices fixed
  - Export subsidies worsen one's own terms-of-trade $\Rightarrow$ $(+)$ net externality along liberalization path $\Rightarrow$ no motive for subsidy rules
- This paper
  - Imperfect competition externalities plus terms of trade
  - Sign of domestic policy externalities is not pinned down by assumption that countries benefit from terms-of-trade improvement
  - Application: sign of subsidy externalities evolves over time

Explaining GATT/WTO Subsidy Rules

- Two important differences between 1947 GATT and 1995 WTO
  - New consensus prohibition of export subsidies
  - New restrictions on domestic subsidies that increase exports
- Initially GATT had shallow integration
  - Works well in theory for subsidies to import-competing industries
- I show strong political motives & low tariffs $\Rightarrow$ more subsidy rules
  - Protecting firm's domestic profits $>$ expanding trade for consumers

Conventional View of Export Subsidies

- Standard competitive economic models imply
  - Importers should think of export subsidies as a gift
    - Improves their terms-of-trade
    - No need for a prohibition
- Mavroidis, Messerlin, & Wauters (2008) on the subsidy agreement
  - Among "least economics-informed agreements in the WTO"
- Janow & Staiger (2003)
  - Ban counters GATT's mission to increase trade volumes

Conventional View of Domestic Subsidies

- Domestic subsidies = first-best intervention for domestic distortions.
  - Subsidy limits are harmful
- Rodrik (2011) and Stiglitz (2006)
  - Limits bad for development, because subsidies could correct static and dynamic externalities
- Bagwell & Staiger (2006)
  - WTO subsidy rules could "completely undermine" GATT
  - "Chilling effect" - Countries skip trade negotiations entirely if they must cut beneficial subsidies

Can Subsidy Limits Improve GATT at Zero Tariffs?

- When tariffs are low

1. Domestic profits (-)
2. **Import tariff revenue (0)**
3. Consumer surplus (+)

- When political economy parameter α is sufficiently high, domestic profit motive outweighs benefit to consumers

Proposition

When political economy motives are sufficiently strong, the GATT can be improved by limits on domestic entry subsidies.

Subsidy Limits Cannot Improve GATT at High Tariffs

- Consider extreme of noncooperative tariffs (approximation of 1947)
- The desire to protect domestic profits motivates both subsidy rules & higher tariffs
- Noncooperative tariffs eliminate any net negative externality from subsidies, as subsidies lead to higher tariff revenue

Proposition

The GATT equilibrium at noncooperative tariffs cannot be improved by subsidy limits.

International Competition Policy

- 1948 Havana Charter: Signed by 53 nations
  - Included provisions on international coordination of competition policy
  - This was a significant step even though U.S. Congress killed it
- 1995 WTO: no direct contracting over competition policy
- What explains 1948 competition policy coordination, but none today?
  - Opposite experience on subsidy rules
  - Prior work (B&S 2002): GATT domestic policy rules were sufficient
  - Horn & Levinsohn (2001): no general competition policy results
- My paper: imperfect competition externalities motivate coordination on stronger, pro-competitive antitrust in 1948
  - Motive decreases & eventually switches sign as tariffs fall

Conclusion

- Desires to directly contract over domestic policies in WTO can be explained by cross-border externalities arising from imperfect competition
- A policy that affects the extensive margin of trade leads to relevant cross-border externalities
  - Policies affecting intensive margin have not led to new problems or rules for trade agreements
- Imperfect competition externalities and political economy can explain the history of subsidy rules in the GATT/WTO
  - When tariffs fall, cross-border effects of subsidies on domestic firms outweigh gains to consumers in government objectives