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Is there a Logic to Current US Trade Policy?

Introduction

The election of Donald Trump as US President on a platform of economic nationalism presents a significant challenge to the global trading system, including pushing back against the multilateral trading system and the WTO, renegotiating the North American Free Trade Agreement (NAFTA), not ratifying the Trans-Pacific Partnership (TPP), and the threat to adopt tough trade policies against China.

In this context, how has the GATT/WTO achieved multilateral tariff reduction and promotion of global trade, and to what extent will it act as a constraint on economic nationalism? To answer these questions, the focus here is on the economic logic of the General Agreement on Tariffs and Trade (GATT)/the World Trade Organization (WTO), the approach to trade policy of the current administration being set in the context of this analysis. The key conclusion is that the underlying economic logic of the GATT/WTO is still relevant, but enforcement of the cooperative agreement it represents will likely be placed under significant strain with threat of increased protection, and even a potential trade war.

Success of GATT/WTO

By some simple metrics, the GATT, and its successor the WTO, has been a very successful institution of international governance. GATT/WTO has established a rules-based system for world trade based on a set of principles enshrined in the GATT Articles, along with a dispute settlement system, that have been universally accepted and respected by its members (Baldwin, 2016). Membership has grown from the 23 countries that signed the GATT in 1947 to 164 countries today. WTO members account for more than 95 percent of both global trade and GDP (Williams, 2008). Over the 70 years of its existence, there have been eight rounds of trade negotiations, resulting in average industrial tariffs being reduced to less than 4 percent, although it should be noted that there is quite a bit of heterogeneity in the level of bound tariffs across both countries and industries (Baldwin, 2016; Bagwell, Bown, and Staiger, 2016).

There have been several empirical studies that have explored the relationship between membership of the GATT/WTO and countries' trade flows. The initial finding by Rose (2004) came as something of a shock to trade economists and policy analysts: membership of the GATT/WTO was not correlated with increased trade flows as compared to non-member countries. Not surprisingly this generated a body of research seeking to overturn Rose's (2004) result, including, *inter alia*, Subramanian and Wei (2007), Tomz, Goldstein and Rivers (2007), and Balding (2010). Subramanian and Wei (2007) provide the most robust response to Rose's (2004) findings, their empirical analysis generating two key results: first, industrial countries that participate in reciprocal trade negotiations enjoy a significant increase in trade; and, second, bilateral trade is greater when both countries engage in tariff reduction as compared to when only one country does.

These results, subsequently confirmed by Chang and Lee (2011) and Eicher and Henn (2011), have been interpreted in the context of developing countries receiving special and differential treatment (SDT) under GATT/WTO rules (Bagwell and Staiger, 2014). Specifically, developing-country members of GATT/WTO have been exempted from its reciprocity norm, i.e., developing countries get a "free pass" on any tariff cuts negotiated between industrialized countries through the most favored nation (MFN) rule by not being expected to cut their own tariffs. The motivation for SDT is ostensibly that developing countries would be able to gain greater access to developed country markets under MFN. However, Bagwell and Staiger (2014) argue that, by not lowering their own tariffs, developing country resources are retained in inefficient import competing sectors. In a simple general equilibrium setting, this acts as a tax on their export competing sectors, i.e., in trade negotiations, "…what you get is what you give…" (Bagwell and Staiger, 2014, p. 99).

Therefore, the conclusion to be drawn from the extant empirical research is that membership of GATT/WTO can be characterized as the outcome of a cooperative game that generates mutual benefits for its members, and particularly those that engage in reciprocal tariff-cutting.

Economic Logic of GATT/WTO

Orthodox trade theory suggests that a small country will unilaterally cut its tariffs, the gains from trade through specialization and exchange subsequently maximizing national income. This is not necessarily the case if a country is large enough to influence its international terms-of-trade, or if public policy is influenced by government preferences other than maximization of national income. In other words, economic analysis of GATT/WTO is about seeking a logical explanation for why a country would seek to be part of such a trade agreement, despite these unilateral incentives to raise tariffs. We might also ask, if it is beneficial to be part of a cooperative agreement such as GATT/WTO, why would a member undermine that agreement or leave it altogether?

In order to answer the first question, a bare bones approach to modeling GATT/WTO is described, the reader interested in more technical details being directed to the considerable body of work by Kyle Bagwell and Robert Staiger, e.g., Bagwell and Staiger (1999, 2002, 2010, 2014), and Bagwell, Bown and Staiger (2016). The workhorse model for their approach is a simple two-good two-country model, where one country (home) has a comparative advantage in producing one good, and a second country (foreign) has a comparative advantage in producing a second good. There are two important price relationships in this setting: local relative prices of goods in the home and foreign country respectively, and world relative prices of goods. In the absence of home and foreign tariffs, local and world relative prices are exactly the same, i.e., markets are fully integrated. If each country sets a tariff on the good it imports from the other country, it drives a wedge between its local and world relative prices, giving protection to their import-competing sector, but at the same time each country is large enough to be able to improve their terms-of-trade through a tariff. Given that local prices determine the level and distribution of incomes earned by factors of production (labor and capital) in each country, various government preferences discussed in the political economy literature can be captured, including national income maximization (Johnson, 1953; Mayer, 1981), and political lobbying models (Grossman and Helpman, 1994; 1995). It is also assumed that holding its local relative price fixed, both home and foreign governments value an improvement in their terms-of-trade.

If there is no trade agreement, the home and foreign countries play out a non-cooperative game in tariffs where each government strikes a balance with respect to the local and world relative price effects of their tariff choices. In terms of local relative price changes, there is a trade-off between the political benefits of redistribution to factors of production employed in the import-competing sector and any losses to domestic consumers. With respect to world relative price changes, the improvement in one country's terms-of-trade necessarily results in a worsening of the other country's terms-of-trade, i.e., each country shifts some of the costs of their protection onto the other country.

Essentially, it is cost-shifting that results in the non-cooperative (higher) tariffs being inefficient. Each government would like to lower their respective tariffs, in order to reduce the domestic distortion and generate more trade, but if done unilaterally they suffer a worsening of their terms-of-trade. Bagwell and Staiger's (1999) insight is to argue that, if the terms-of-trade externality can be neutralized, it will be beneficial for both countries to lower their tariffs. In other words, suppose that neither country's government cared about terms-of-trade effects, tariffs will be set to satisfy domestic political objectives alone. These tariffs are termed "politically-optimal tariffs", which would either be zero if each government seeks to maximize national income through free trade, or they would be positive in order to satisfy domestic political-lobbying constraints, but importantly, they are lower than those in a non-cooperative game. Therefore, if countries enter into a trade agreement, they will seek mutual reductions in tariffs generating an increase in national economic welfare.

Given this model structure, Bagwell and Staiger (1999) argue that application of the principle of reciprocity in GATT/WTO does result in tariff reductions that raise economic welfare. Specifically, reciprocity means that for either country to offer a tariff concession, it requires a tariff concession from the other country such that the world relative prices remains unchanged, i.e., terms-of-trade effects are ruled out. Tariff-cutting continues until one of two conditions is satisfied: either one country's government achieves its preferred local relative price before the other or "politically-optimal tariffs" are achieved. Of course, the idea that trade negotiators are concerned with the technicality of terms-of-trade effects is likely unrealistic, but as Bagwell and Staiger (2010) point out, this concept can be expressed in terms of market access. A tariff, while creating a terms-of-trade benefit for the importing country, also results in a loss of market share for the exporting country. In other words from a practical standpoint, trade negotiations are about mutual concessions on market access.[1]

Reciprocity also helps explain the idea behind "withdrawal of equivalent concessions" as part of the dispute settlement mechanism of GATT/WTO. Standard game theory would suggest that both home and foreign countries have an incentive to deviate from the low-tariff equilibrium that results from a trade agreement. Consequently, in a repeated game, a credible punishment threat is reversion to the non-cooperative tariff equilibrium. In practice, the rules of GATT/WTO seek to maintain the balance of concessions and avoid the use of punitive actions (Staiger, 1995; Zissimos, 2007). Essentially, if the home country were to deviate from the agreement by raising its bound tariff, this would imply a loss of previously negotiated market access for the foreign country. Assuming that this action is not "abusive", under GATT/WTO rules, the exporting country is allowed to withdraw an amount of market access equivalent to what the home country has withdrawn – by implication, there will be no change in either country's international terms-of-trade. However, if the home deviates in an "abusive" manner, reversion to the non-cooperative tariff equilibrium is possible. In other words, the objective of GATT/WTO rules is to ensure that retaliation by one country against the unilateral action of another is proportionate, thereby minimizing the chance of a trade war.

As well as reciprocity, the principle of non-discrimination in GATT/WTO also requires that tariffs be applied on an MFN basis, i.e., in the simple model, if the home and foreign country agree to lower their tariffs, those tariff cuts should be extended to any other country that is a member of GATT/WTO. Importantly, MFN in combination with reciprocity can minimize the risk of third-country spillovers (Bagwell and Staiger, 2010). Suppose the home country exports a good to two foreign countries, and imports another good from both countries, and it chooses to enter into reciprocal tariff reduction with foreign country 1, but each offers their respective tariff cuts to

[1] There is a growing body of empirical evidence supporting the terms-of-trade theory of trade agreements, e.g., Broda, Limão, and Weinstein (2008), Bagwell and Staiger (2011), Bown and Crowley (2013), and Dhingra (2014).

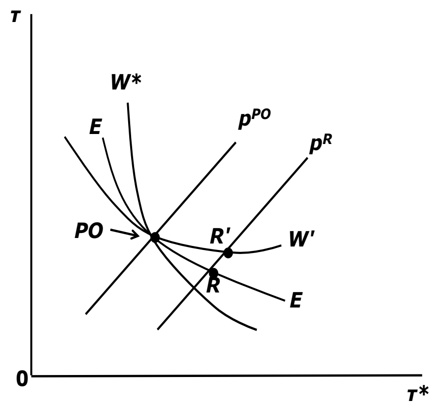
foreign country 2 under MFN. The end result is that given foreign country 2 keeps its tariff fixed, negotiations between the home and foreign country 1 under MFN ensure that there is a single world relative price that remains unchanged, i.e., foreign country 2 experiences no change in its export volume. It should be noted though, that without reciprocal tariff cuts by the home and foreign country 1, the world relative price will change, thereby affecting foreign country 2's export trade volume – in other words, MFN on its own is not sufficient to prevent concession erosion.[2]

Economic Nationalism and GATT/WTO

Is it possible to rationalize the trade policy approach of the current US administration in the context of this large body of theoretical and empirical analysis of the GATT/WTO? If the existing equilibrium is efficient in the sense that each country is picking a tariff to maximize its own economic welfare given the other country's tariff, and each country's tariff choice is politically optimal, there are no obvious gains to economic welfare to unilaterally raising tariffs, i.e., it should be renegotiation-proof (Bagwell and Staiger, 1999). However, it is possible that the existing tariff equilibrium, is efficient but not politically optimal, and is, therefore, not renegotiation proof. Given sufficient domestic political changes within the United States, it might be optimal for the Administration to withdraw some tariff concessions under GATT Article XXVII, after which the affected country would be permitted to withdraw equivalent concessions.

These two arguments are described in figure 1. Given home US and foreign country tariffs, T and T^*, EE represents efficient pairs of these tariffs, where the points PO and R describe two particular tariff combinations. The lines p^{PO} and p^{R} trace out pairs of tariffs for which each country's terms-of-trade remain constant, while W and W^* trace out pairs of tariffs that are individually politically-optimal for the US and foreign country respectively. The latter schedules also intersect at PO which is the jointly politically-optimal combination of tariffs. If the US economy has actually reached this point after successive rounds of trade negotiations, it cannot be beneficial for it to raise its tariffs unilaterally, i.e., it is renegotiation proof.

Figure 1: Tariff equilibrium



Suppose instead, the US economy starts at a point such as R, where W (not shown) is sufficiently close to R such that, there is still no incentive to withdraw any tariff concessions. Now allow for the current US administration to have different political objectives to those held by the previous administration, represented by W'. This puts pressure on the US to withdraw some tariff concessions, the foreign country responding by withdrawing equivalent concessions in such a way as to preserve the world price ratio at R' where the US now maximizes its economic welfare. Under these circumstances, there may be a rationale for the US to withdraw tariff concessions, but its willingness to do so is constrained by the retaliation allowed to the foreign country by the GATT/WTO rules.

The key to this argument is that the preferences of the current administration have shifted enough in favor of renegotiating previous tariff concessions in the GATT/WTO. Why would they choose to do this? First, one could appeal to a political lobbying model such as Grossman and Helpman (1995) to argue that the US is seeking to increase the tariff applied to the import-competing sector due to less weight being attached to average social welfare, i.e., the costs imposed on individual voters are not weighed as heavily in the policymaker's decision calculus. Also, in a

[2] Empirical evidence supporting the reciprocity and non-discrimination principles in GATT/WTO negotiations can be found in Bown (2004), and Limão (2006, 2007).

political lobbying model where loss aversion on the part of owners of specific factors in the import competing sector matters (Freund and Özden, 2008), it may be that the world price has fallen below the reference price, and so an increase in the US tariff is sought.

However, this argument is difficult to reconcile with empirical research by Fajgelbaum and Khandelwal (2016), who find that that the burden of increased protection is likely to fall disproportionately on individuals at the lower end of the income distribution, many of whom likely voted for Donald Trump. In addition, if the US import-competing industry has been long in decline, by the logic of Freund and Özden (2008), the level of protection should be declining not increasing, as sensitivity to losses diminishes, an argument they support empirically with reference to the US steel industry. Interestingly, President Trump did authorize an investigation under the Trade Expansion Act of 1962, Section 232 into whether steel imports are a threat to US national security, and in particular whether excess capacity in the Chinese steel sector has resulted in their dumping steel on the world market. Keynes and Bown (2017a) suggest that the premise for such an investigation misses the point for several reasons: first, the decline in employment in the US steel industry happened long before China became a significant player in the world market; second, the bulk of US steel imports come from Canada; and, third, China is proactively seeking to reduce its production capacity. Keynes and Bown (2017a) conclude that China is not willing to continue reducing capacity if President Trump unilaterally implement tariffs in order to look tough.

A second possibility is that the US seeks to rebalance trade with countries with whom it is has a bilateral trade deficit, the objective being to negotiate "more reciprocal" tariffs with such countries. For example, the current administration seems to believe that reciprocity should result in uniform reciprocal tariff rates, i.e., if the US has a tariff rate of 2.5 percent on automobiles, then China should also have a 2.5 percent tariff on automobiles (Bown, Staiger and Sykes, 2017). However, this view does not appear not to recognize the exact nature of reciprocity in GATT/WTO which incorporates the notion of "first-difference" reciprocity, i.e., "…tariff cuts are to proceed via bargaining that reflects a balance of perceived advantage at the margin rather than by…perceived full equality of market access and reverse market access (or what in modern American parlance, is pithily described as 'level playing field'…" (Bhagwati, 1988, p.3).

Third, it is possible that the current administration does not fully appreciate the GATT/WTO "latecomers" problem. While developing countries such as Brazil, India and China might like to offer tariff cuts in the GATT/WTO, developed countries such as the US do not have much to offer in new rounds of reciprocal tariff-cutting, i.e., there is essentially "globalization fatigue" (Bagwell and Staiger, 2014). Bown, Staiger and Sykes (2017) argue that the way to approach this problem, is not through "leveling the playing field", i.e., unilaterally threatening to raise tariffs if developing countries such as China do not lower their tariffs, but instead seek a new reciprocal trade bargain within the GATT/WTO. Bagwell and Staiger (2014) address this issue in terms of how to "make room" for the developing countries at the GATT/WTO table. Specifically, they argue that the traditional reciprocal exchange of market access through tariff concessions will have to be replaced with an approach that involves developed countries lowering/eliminating their agricultural export sector subsidies, thereby improving the terms-of-trade of developing country agricultural exporters, in exchange for which developing countries reduce their tariffs on imports of manufactures.

Conclusion

The overall conclusion to be drawn is that the current administration's objective function differs from those of previous administrations. While previous administrations participated in decades of successful rounds of multilateral tariff cuts, the current administration is following a path of economic nationalism and pushing back with threats of not playing by the accepted rules of international governance. The approach of the current administration is to address what they see as "unfair trade practices" by following unilateral policies, renegotiating or withdrawing from trade agreements, and threatening to apply import protection (Handley and Limão, 2017). Essentially, President Trump believes that his approach to bargaining will be much more likely to get a "better deal" for the US (Bown, Staiger and Sykes, 2017). In other words, rather than being the win-win of reciprocal and multilateral exchange of market access as a resolution to an inefficient non-cooperative tariff equilibrium, it would seem that trade agreements are instead perceived as a zero-sum game, where until now, the US has typically lost, and its trading partners have won.

This view of trade agreements certainly appears to characterize the current administration's attitudes towards dispute settlement within GATT/WTO. The US has been blocking the appointment of two judges to the WTO's Appellate Body, and plans to block the appointment of a third when the current incumbent steps down this December (Keynes and Bown, 2017b). The administration is attempting to hold the WTO hostage, because they feel that in the WTO's dispute settlement process, the US is being denied the benefits it signed up for. Specifically, US Trade Representative Robert Lighthizer is of the view that these benefits included the right to impose anti-dumping duties, and the fact that the US has lost a significant number of cases involving anti-dumping actions, means that the judges are denying the US its benefits (Wroughton, 2017).

The administration's attitude to dispute settlement in the GATT/WTO is also mirrored in its renegotiation stance over dispute settlement in NAFTA. Specifically, NAFTA's Chapter 19 is designed to resolve disputes over anti-dumping and the use of countervailing duties, based on an arbitration panel picked by the US, Canada and Mexico (*The Economist*, 2017). Chapter 19 has its origins in the Canadian-US Free Trade Agreement (CUSFTA) signed in 1988 when Canada sought to restrain the US from using trade remedies such as anti-dumping duties against Canadian exports. Essentially the current administration wants to scrap Chapter 19 so that there are no restrictions on its use of trade remedies (Keynes and Bown, 2017c).

The current administration's non-reciprocal approach to trade agreements represents a serious threat to the multilateral trading order. While a trade war has not broken out yet, significant tension has been created by the US approach. Most notably, the NAFTA renegotiations have resulted in Canada seeking redress against the US through the WTO (Bown, 2018).

Specifically, Canada has made a request for consultations over US anti-dumping and countervailing duty investigations, such a request formally initiating a dispute at the WTO. This initial skirmish has the potential of escalating into a significant battle, especially if the US were to end NAFTA. If the latter were to occur, and the US unilaterally raised tariffs against Canadian imports, Canada would eventually be forced into retaliating through the WTO (Bown, 2018). In other words, the zero-sum philosophy of the US in dealing with the NAFTA renegotiations has the potential to spill over into the multilateral regime of the GATT/WTO, where the principle of reciprocity holds. In other words, by undermining the NAFTA dispute resolution mechanism, the US runs the risk of forcing Canada's hand in seeking a ruling from the WTO, and possibly the right to retaliate proportionately if the US fails to comply with that ruling.

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