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Trade Agreements: The Important Role of Transparency

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International trade can be inhibited in two ways; through the use of mechanisms that directly alter the flow of goods and poor transparency in the rules of trade. The former includes tariffs and other border measures, subsidies and non-tariff barriers. The effect on trade flows resulting from issues of transparency is indirect. When the rules of trade are unclear for firms considering investing in trade related activities, the risks associated with those investments increase and investment is inhibited. If there is less investment in trade related activities, trade flows will be reduced. Poor transparency exists in contingent protection measures such as anti-dumping – currently on the agenda of the Rules negotiations at the WTO and – customs and related procedures – on the agenda in the Trade Facilitation negotiations. Increasing transparency can have important trade liberalizing effects. Trade negotiators often focus on achieving a *big* result from reductions in border measures and subsidies where there may be considerable resistance from protectionist vested interests. If progress can be made in increasing the transparency of trade rules, a less ambitious result may be acceptable for the direct aspects of trade liberalization.

Keywords: investment, liberalization, risk, transparency

Introduction

> All merchants may enter or leave England unharmed and without fear, and may stay or travel within it, by land or water, for purposes of trade, free from all illegal exactions, in accordance with ancient and lawful customs. This, however, does not apply in time of war to merchants from a country that is at war with us. Any such merchants found in our country at the outbreak of war shall be detained without injury to their persons or property, until we or our chief justice have discovered how our own merchants are being treated in the country at war with us. If our own merchants are safe they shall be safe too.
>
> Magna Carta (1215)[1]

It is interesting, with all the problems the barons of England were having with King John in 1215, which the Magna Carta was drafted to deal with, that a "free trade" clause was included in the text of the charter. Of course, in 1215 international trade was a function of the movement of merchants. In the absence of all the market-supporting institutions that have evolved to facilitate the international movement of goods – what Douglas North (1987) calls "specialized interdependence", whereby sufficient institutional constraints are in place to inhibit cheating, shirking and opportunism to a sufficient degree to allow exchanges to take place on an impersonal basis – merchants travelled with their goods.

Goods were acquired by the merchant directly from a production unit or a "fair" in one country and then transported to the other country, with the merchant accompanying the goods. The merchant likely had to hire, in addition to the men and animals actually engaged in the transport function, men at arms to protect his goods. He also had to carry considerable cash to pay tolls and to buy "protection" from both bandits and local governments along his route. Possessing this much cash probably meant that a couple of sturdy relations had to be brought along to protect the merchant's person from, if nothing else, the men at arms hired to protect the goods. Disposal of the goods probably took place at a "fair" in the destination country, with the merchant directly engaging in the sale to ensure he received payment. The money received from the sale was then used to purchase local products that the merchant hoped he could sell profitably back in his home country, and the return journey commenced. The merchant's expectation was that the price differentials between the source and destination countries would be sufficient to yield a profit after all the

transportation and transaction costs were deducted. The transaction costs were high and transport difficult, so the volume of trade was very small.

Thus, trade was dependent on the ability of merchants to move between countries. While the merchant faced many unknowns and risks, the state – as embodied in the monarchy – was also a risk. Kings were always short of cash, and foreign merchants' purses and goods presented easy targets. The "king's men" were also likely more difficult to buy off. Wars and threats of war were frequent and, given the time it took to journey to foreign destinations, merchants could easily be caught on the wrong side of the border. Trade, small though it was, was considered sufficiently important for there to be a desire to have transparency regarding the actions of the king. The "free trade" clause in the Magna Carta is clear and to the point. The king agrees not to interfere in the international movement of merchants. The merchants are still subject to local laws (i.e., accordance with ancient and lawful customs) but not harassment by the king. In time of war, the foreign merchant and his property are protected. There is even an element of a "cooperative game" to limit beggar-thy-neighbour retaliation by tying the wellbeing of foreign merchants to the treatment of England's merchants in the enemy country.

It would be an interesting avenue of inquiry for economic historians to determine the efficacy and longevity of the "free trade" provision of the Magna Carta. One thing is, however, clear: those wishing to engage in international trade were seeking increased transparency regarding the potential actions of governments, a theme that has remained central to trade agreements down to the present.

Trade Transparency and Trade Liberalization

Firms, not governments, engage in trade.[2] Trade agreements are about the activities of governments.[3] International trade agreements exist primarily to provide firms that wish to engage in international commerce with transparency regarding the activities of governments. If the activities of governments are unconstrained, then making investments that will allow international commercial opportunities to be capitalized upon is extremely risky. For example, if governments can impose border taxes as they see fit, foreign firms that have invested in developing an export market face the possibility that the government in the importing market will raise border taxes on the goods it is shipping – to raise revenue or provide protection – meaning that the expected return on investment is considerably reduced or nullified. A prudent firm may opt not to invest in the trade-related activity. In such a case, however, the benefits from trade are forgone. Governments understand the benefits of trade[4] and, hence, have agreed to limit their actions in international trade agreements – to reduce the

risks for firms (Kerr and Perdikis, 2003). One result has been the evolution of the tariff as the preferred border tax in trade agreements (Loppacher and Kerr, 2007). Tariffs rates are pre-announced and fixed, unlike alternative border taxes such as variable levies, which can be altered as market conditions change.

In the WTO, countries have agreed to provide an upper "bound" to their tariffs and to publish those bound rates by notifying them to the WTO. This transparency provides a basis upon which firms can plan their investments.[5] Of course, high rates of bound tariffs reduce the set of profitable opportunities available to firms but they are not risky. They represent opportunities forgone rather than risks that must be factored into investment decisions. Of course, firms would like the set of profitable opportunities expanded through the reduction of tariffs, but transparency is of fundamental importance.

The multilateral institutions that have been put in place to provide transparency are also expected to provide a forum where trade liberalization can be pursued by member states. The WTO has been given trade liberalization as a specific objective by its member states. Regional and bilateral trade agreements are also expected to lead to the liberalization of trade. The rate at which liberalization is to progress is determined by negotiations.

Often, the focus of trade negotiations is on the potential for liberalization. Improvements in the international commercial environment, however, can also come from improving transparency. Improvements to transparency are not, however, the *stuff* of news headlines, nor do they necessarily grab the interest of politicians. A 60 percent reduction in tariffs or a US$15 billion reduction in trade-distorting subsidies are tangible, and their effects on trade volumes are easily envisioned. Clarification of sanitary or phytosanitary standards, of what can be considered legitimate food aid or of the threshold for industry participation that must be met for a dumping case to be initiated, for example, are all measures that would increase transparency. These improvements in transparency may well reduce risk for firms and lead to increased investment in international trade activities that ultimately produce trade results that are as important as those arising from liberalization.

Trade negotiators often fret that the negotiations are not sufficiently *ambitious*; they fear that a *light* agreement will not be saleable politically or that a *small* result will erode support for multilateral institutions or a regional agreement. While there may be some basis for this perception, the reality is that significant progress on liberalization has almost never been manifest in negotiations. While there has been significant progress in the reduction in the average level of industrial tariffs, it took the period from 1947 to 1994, and eight negotiating rounds, to achieve. None of the individual

rounds produced a *large* result. Of course, agricultural tariffs were excluded from liberalization until the Uruguay Round (Gaisford and Kerr, 2001). If one examines even the least ambitious of the proposals for improved market access for agricultural products in the Doha Round – tariff reductions – they would not be considered *light* by the standards of any of the individual rounds that reduced industrial tariffs up to and including the Uruguay Round. The Uruguay Round, where agricultural subsidies were disciplined for the first time, did not lead to a great deal of liberalization – rather it prevented the further escalation of the subsidy war between the United States and the European Union (Kerr, 2000) – but it provided considerable transparency for firms considering investments associated with agricultural trade. The new Agreement on Trade in Services negotiated during the Uruguay Round has been criticised because it did not produce significant liberalization through the opening of sectors to investment, yet it has been positively viewed by business because it increased transparency, thus reducing the risks associated with international investment (Loppacher and Kerr, 2006).[6] In the one area where an *ambitious* outcome was achieved during the Uruguay Round negotiations, the Agreement on Trade Related Aspects of Intellectual Property (TRIPS), whereby developing countries agreed to move to developed-country norms of protection in a relatively short period (Gaisford and Richardson, 2000), there have been considerable issues regarding enforcement[7] and attempts to retreat from the level of *ambition* that was agreed.[8]

Significant degrees of trade liberalization are always difficult to achieve. Periods of economic disequilibrium, however, are likely to make achieving liberalization even more difficult. This is because during times of disequilibrium many firms have difficulty assessing whether liberalization will be beneficial for them. Firms seeking protection, however, can be more secure in their assessments. The first decade of the 21st century has to date been one of considerable global disequilibrium, which may explain why there has been little private sector enthusiasm for the Doha Round. The disequilibrium has a number of sources. The major source of disequilibrium has been the integration of China into the global economy. China, with its low labour costs, has altered the comparative advantage of many countries and has put particular pressure on manufacturing sectors either though import competition from Chinese goods or increased competition for export markets. As China develops, additional sectors of its economy become internationally competitive, thus continually adding to disequilibrium even as industries previously disrupted by Chinese competition find new equilibriums. China has also been putting upward pressure on resource and energy prices, further obfuscating the desirability of trade liberalization.

India is also actively engaging the international economy for the first time (Perdikis, 2000). Particularly disruptive, at least for the confidence of firms and employees in developed countries, has been India's ability to effectively use the technological advances in electronic communications to capitalize on its low-cost labour, both unskilled (call centres) and skilled (computer programming). Outsourcing has led to concerns pertaining to future competitiveness in developed countries far beyond its actual effect.

Of course, the internet and the rise of e-commerce have lowered the transaction costs – particularly information costs – associated with engaging in international commerce for both consumers and firms. E-commerce has imposed significant changes on a number of sectors, and these changes will take a considerable period to work through. Faced with this new form of potential competition, some firms might find trade liberalization to be less desirable than they had previously perceived it to be.

In agriculture, traditional exporters such as the United States and Australia are facing significant competitive challenges from developing countries, in particular Brazil and Argentina, in crops such as soybeans and livestock products such as beef. Advances in agricultural biotechnology are also altering international competitiveness and changing trade flows (Smyth et al., 2006), given the regulatory disagreement between the United States and the European Union over trade in the products of biotechnology (Isaac and Kerr, 2007). There has also been a major external shock to the grains and oilseeds sectors resulting from attempts by the United States and the European Union, among others, to foster the production of biofuels. This may lead to a reorientation of grain trading patterns. Further, the rules of trade that will apply to biofuels are far from clear (Loppacher and Kerr, 2005).

A number of governments are also contemplating major policy changes to deal with climate change; such policy changes could have important ramifications for the international competitiveness of particular industries, depending upon what is negotiated in the successor to the Kyoto Agreement (Gaisford et al., 2004). If oil prices remain at levels that are higher than historical norms over a considerable period, long-run adjustments will take place that will also alter the relative international competitiveness of some industries.

Given this degree of disequilibrium, it is probably not surprising that there appears to be little enthusiasm among the business community for an *ambitious* conclusion to Doha Round and for trade liberalization in general. Trade negotiators (and sometimes their political masters) and some WTO officials, however, still appear wedded to the idea that major trade liberalizing concessions are required for a successful round – and this may be preventing an agreement being reached. An agreement with modest

achievements on liberalization could still garner considerable support from international business if it provided important gains in terms of transparency. A good result in the area of trade facilitation could be very valuable. The *Rules* negotiations pertaining to dumping could do much to reduce the ability of domestic dispute resolution institutions to act in capricious ways when collecting information, determining whether dumping is taking place, assessing whether the domestic industry is suffering injury and calculating the antidumping duties to be applied. More clarification could also arise from the GATS negotiations. Conclusion of the TRIPS negotiations on geographical indications and the protection of traditional knowledge would increase transparency in these areas, which are very important for investment decisions in some sectors. The Doha agenda makes specific reference to "Transparency in Government Procurement" – an area where a positive conclusion would be particularly welcome for a range of private sector interests. E-commerce is another area where negotiations are mandated and a great deal of clarification is desired. These are all areas where much that would be valued by industry could be achieved without major commitments to liberalization.

More difficult is the work of the WTO Committee on Trade and the Environment, which was charged with sorting out the relationship between the WTO and multilateral environment agreements such as the Biosafety Protocol (BSP). The BSP, for example, has adopted a set of rules for trade in the products of agricultural biotechnology that are in direct conflict with WTO commitments (Holtby et al., 2007). There is little that is more frustrating for firms than two sets of trade rules that contradict each other and where there is no consensus on which agreement takes precedence (Phillips and Kerr, 2002).

Conclusion

As with the merchants engaged in international commerce in the 13th century who wanted increased transparency as to the actions of King John – and his successors – firms today stand to gain a great deal from increased transparency in the rules of trade. Transparency reduces risk and, hence, can encourage trade-related investment. These increased investments may bring gains from trade that rival those that come from liberalization in the form of lower tariffs and reductions to trade-distorting subsidies.

In times of disequilibrium in the international economy, it may be easier to make progress in increasing transparency than in lowering tariffs or reducing subsidies. Therefore, a modest success in direct liberalization may not mean that the negotiations have failed, so long as transparency has increased. To achieve success in improving

transparency, it may be necessary to redeploy negotiating resources to those areas where such improvement can be achieved. Further, lack of *ambition* in direct trade liberalization should not on its own be a reason to delay unduly, or fail to reach, an agreement.

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Endnotes

1. *Text of the Magna Carta* (n.d.), clause 41. Of course, the Magna Carta was originally written in Latin. The original of clause 41 is: *Omnes mercatores habeant salvum et securum exire de Anglia, et venire in Angliam, et morari, et ire per Angliam, tam per terram quam per aquam, ad emendum et vendendum, sine omnibus malis toltis, per antiquas et rectas consuetudines, preterquam in tempore gwerre, et si sint de terra contra nos gwerrina; et si tales inveniantur in terra nostra in principio gwerre, attachientur sine dampno corporum et rerum, donec sciatur a nobis vel capitali justiciario nostro quomodo mercatores terre nostre tractentur, qui tunc invenientur in terra contra nos gwerrina; et si nostri salvi sint ibi, alii salvi sint in terra nostra* (*Magna Carta*, n.d.). [Note: In my original preparation of this manuscript I used the Latin version of the text without translation – a bit of cheek I must admit. Alas, the reviewers did not appreciate my attempt at irony in an essay about transparency and insisted that an English version be substituted. I think I also hoped that the Latin version would spur readers to seek the translation themselves – a relatively costless task in the age of the internet – and in the process peruse for themselves the Magna Carta, which is an amazing document. It also got me thinking about transparency and economists. I began my training in economics in the 1960s, and we were required to read some (but not many) works of economists written in the 1930s, 1920s and earlier. In many cases these papers started with a quotation written in Latin or Greek with no translation provided. I suspect that by the 1930s those sufficiently fluent in Latin or Greek to read the quotations were already a small set. Some papers would come to crucial points in the discussion and lapse in to Latin or Greek, leaving me, who had never studied either, mystified. I distinctly remember being assigned one reading with 30 pages of particularly dry

exposition, only to reach the final page, where the important and insightful conclusion to this piece of scholarship would be revealed, and being presented with 40 lines written in Greek – I have no recollection of what the paper was about but I remember my frustration over lack of transparency very distinctly. Economists still have a reputation for lack of transparency – in particular in failing to provide a translation – the language has changed but Greek remains the preferred alphabet.]

2. Of course, to a limited degree governments directly engage in international trade, and state trading agencies exist.
3. Some activities of private firms are, however, dealt with in trade agreements. One example is dumping, which pertains to the pricing practices of private firms.
4. Of course, governments also must balance the need, at times, to respond to domestic pressure from those seeking protection, with the benefits of trade.
5. Of course, some risk remains because the tariffs countries actually charge – applied rates of tariffs – may be considerably lower than the bound rate. Applied rates can be changed as long as they don't exceed the bound rate. Thus, the rates notified to the WTO are only upper bounds.
6. For a discussion of foreign investment and capricious activities of governments see Kerr and Anderson (1991).
7. See Gaisford et al. (2002) for a discussion of TRIPS enforcement.
8. In the case of intellectual property in pharmaceuticals when there is a health emergency, an exemption was negotiated as part of Doha Ministerial Meeting of the WTO. Developing countries see this concession as the *thin edge of the wedge* in the battle to limit the scope of their commitments.

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