

# The Political Economy of Reciprocity\*

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"In an important sense the GATT does not reflect the views of twentieth century economists and never has done: the exchange of trade barrier 'concessions' is at best in the realm of political economy rather than straight economics" (Snape 1994).

We have "a somewhat surrealist situation - the world's leading organisation in the field of international trade explaining its policies to the world in terms of voodoo economics rejected by virtually every professional economist in the field" (Hudec 1987).

The object of this paper is to answer two questions:

1) If removal of trade barriers is in each country's own interest, why are trade negotiations traditionally conducted on the principle of reciprocity, exchange of "concessions"?

2) Why, if the political economy case for reciprocity is so compelling, have so many countries, especially in the Asian-Pacific region, in recent years nonetheless embarked on unilateral trade liberalisation?

But first some historical background.

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### Concise history of reciprocity

Reciprocity is not new. The notion that a country "favours" another by admitting that country's products more freely to its own markets is implicit even in the most benign form of reciprocity, the most favoured nation (MFN) principle, and this goes back centuries. "Long before the beginning of the 19th century, equality of treatment in tariff matters as between foreign countries had become a sort of principle of international comity" (Viner 1950, p. 5). "The European States began as early as the 17th century to introduce the most favoured nation clause in their commercial treaties" (Haberler 1936, p. 363).

In its more restrictive, bilateral or conditional, form, reciprocity in trade agreements goes back at least to 1794 when the US Congress authorised President Washington to suspend restrictions on imports from other countries "whenever he was satisfied that such countries had suspended their discriminatory restrictions upon the goods and vessels of the United States" (Larkin 1940, p. 23). Such action was taken by several presidents in the following twenty years. Their object, supported by moderate protectionists, was to induce Congress to reduce US tariffs in return for suspension of discriminatory measures by other countries against US trade. The USA throughout the 19th century used the conditional version of the principle of reciprocity: MFN treatment was accorded only to countries guaranteeing it to the USA. In practice, as Haberler (1936, p. 365) pointed out, conditional MFN meant little more than refusal to grant MFN treatment.

In 1922, in the Ford-McCumber Act which gave the President sweeping powers to use tariffs to "equalise costs" between foreign and domestic goods, the USA turned to unconditional MFN, determined to ensure that no foreign country would grant tariff concessions to a third country without extending the same favour to US goods, but recognising that "to be prepared to enforce this principle the US must abide by it" (Larkin 1940, p. 27). Conversely, "if the President should concede tariff reduction on the goods from one country without demanding some similar trade advantage, then every other country would demand the same thing. His bargaining power would be lost" (*ibidem*, p. 40).

In Britain, the emergence in the 1870s and 1880s of the "Reciprocity Free Trade Association" and similar organisations demanding "fair" rather than "free" trade marked the beginning of the retreat from free trade which culminated in the adoption of protection in 1932 (Bhagwati-Irwin 1987, p. 112).

In 1934, the principle of non-discrimination embodied in MFN became the cornerstone of US trade policy. The Great Depression had led to a worldwide epidemic of beggar-my-neighbour policies which drastically aggravated the contraction of world trade caused by declining incomes. It hit US exports particularly hard because most other countries were compelled or tempted to use balance of payments deficits with the USA to justify protectionist measures. To relieve the pressures on US exports, Roosevelt's Secretary of State, Cordell Hull, secured the passage of the Reciprocal Trade Agreements Act which empowered the President to enter into trade agreements with foreign countries for the reciprocal reduction of tariffs and other trade restrictions, subject to unconditional MFN treatment (Arndt 1944, p. 81). In the following years, many such agreements were concluded.

"Equal access to trade" through non-discrimination became one of the Western Allies' war aims, proclaimed by Roosevelt and Churchill in the Atlantic Charter of 1941 and the basic principle of the Havana Charter of 1946, from which emerged, as the residual legatee of the stillborn International Trade Organisation, the General Agreement on Tariff and Trade (GATT). MFN, however qualified by various exceptions, such as actual or nascent customs unions and preferential arrangements in force in former colonial empires, became the foundation of the GATT code for freer trade.

Reciprocity, appears in the preamble to the General Agreement where the contracting parties express their desire to contribute to its objective "by entering into reciprocal and mutually advantageous arrangements" and in subsequent articles, such as Article 28 which enjoins the contracting parties to "endeavour to maintain a general level of reciprocal and mutually advantageous concessions not less favourable to trade than that provided for in the present Agreement" (United Nations 1947, p. 61).

Reciprocity, as envisaged in the GATT which focuses on matching reductions, "first-difference reciprocity", as it has been called (Bhagwati-Irwin 1987, p. 117), could be seen as helping governments gain acceptance by domestic interest groups for a policy of trade liberalisation and thus for the goal of a free multilateral

world trading system. This is much less plausible for the "full reciprocity" version, exemplified more recently by aspects of US and EC trade policy, which aims at broadly matching levels of restriction or openness of trade, both with respect to individual sectors (e.g. semi-conductors) and bilateral trade balance (e.g. US-Japan). This is discriminatory and generally not conducive to free multilateral trade.

Reciprocity is of the essence of international trade negotiations. Freer trade is a means to improved market access. Countries "favour" one another by reducing tariffs. Trade agreements are about reciprocal "concessions". As Snape (1994, p. 7) has put it, "the foundations of GATT that reductions in trade barriers are beneficial, that tariffs are to be preferred to quantitative or other restrictions, that trade barriers should not discriminate between foreign countries and that trade barriers should be transparent – are fairly sound from an economic perspective. But the concessions framework has many costs: it is often held that it reinforces mercantilist views of international trade. It encourages the idea that other countries' trade barriers are a greater burden than one's own barriers, or even that one's own barriers are not a cost at all".

### Why reciprocity?

What accounts for the traditional and almost universal adherence to reciprocity as the guiding principle of trade policy? The answer would seem to be twofold: The superior power of producer interests concerned to gain or maintain market access in industries subject to foreign competition and the popularity of "voodoo economics" (in Hudec's sense).

*Market access as major policy objective.* Tariffs and other trade barriers benefit producers (employers and workers) in protected industries at the expense of (a) their foreign competitors, (b) producers in the country's export industries and (c) consumers of their products (and, in so far as protection impairs the efficient use of the country's resources, the public at large). In shaping the country's trade policy, the interests of producers in domestic protected industries will obviously prevail over those of their foreign competitors. They will also

tend to prevail over those of domestic household consumers because producers are more concentrated and better organised. The gains from trade liberalisation have the characteristics of a public good. (The interests of producers in protected import-competing industries may, however, come up against the interests of producers using imported inputs.)

It is primarily to the balance of power between producers in import-competing industries and actual or potential export industries that reciprocity is relevant. Producers in protected import-competing industries may be willing to support "concessions" in the form of lower tariffs if they themselves expect to be able to compensate for loss of market share in the domestic market by gains of market share in exports to foreign markets made more accessible by foreign "concessions". Alternatively, a reciprocal exchange of concessions in a trade agreement may be politically feasible because the interests of producers in protected import-competing industries are overpowered by producers in different (e.g. mining or rural) industries.

To put the matter so starkly is to oversimplify. Consumer interests may carry political weight. Diplomatic considerations may favour unilateral concessions to foreign producers, as in the case of preferences to developing countries (perhaps misguidedly – it might well have been in the developing countries' own interest, as Frank 1978, p. 23, has pointed out, to be required to participate in reciprocal tariff reductions under GATT). And of course, governments may be influenced in their trade policies by economists and other advocates of freer trade as in the national interest. But the dominant influence on trade policy has generally been the pursuit of market share by producer interests. National governments have made the enhancement or defence of their industries' market shares the primary objective of trade policy, with reciprocity as the primary negotiating tactic. In Haberler's (1936, p. 376) words, "even countries which are in principle Free Trade must face the *tactical* problem of inducing their Protectionist neighbours to lower their duties". From President Washington's use of reciprocal concessions to diminish discrimination against US exports, to the infinitely painstaking haggling in the GATT Uruguay Round, the primacy of producer interests over those of consumers (or, for that matter, over the efficiency of the economy) has made reciprocity, for most of modern history, the tortuous path to freer trade. Indeed, it has sometimes led governments to impose or

raise tariffs as bargaining counters, the so-called “bargaining tariffs” – only to find them hard to bring down again once vested interests have become ensconced. There have also been times, as during the early 1930s, when reciprocity has deteriorated into trade wars, reciprocal infliction of damage rather than reciprocal concessions. Reciprocal trade liberalisation and beggar-my-neighbour trade war are both likely to end up with an unchanged trade balance, but liberalisation at a higher and trade war at a lower level of trade and welfare.

*Voodoo economics.* Producer interests in protected industries would not find it so easy to insist on reciprocal concessions for any reduction in tariffs were it not for the prevalence of protectionist fallacies among the general public in most countries.

Mercantilist notions – “exports are good, imports are bad” – are deeply ingrained in the minds of most of the unsophisticated public. They readily accept the terminology of a “favourable” balance of trade and of tariff cuts as concessions, not because they still hold to the 17th century mercantilist idea that it is desirable for a country to accumulate “treasure”, but chiefly because they think that exports create and imports destroy jobs. They do not make the intellectual effort to visualise that if every country resorts to attempts to export its unemployment, all are worse off. Naïve chauvinism (“buy Australian”), obviously vulnerable to the same *reductio ad absurdum*, also plays a part.

Economists concede that protection (and therefore insistence on reciprocity) may sometimes be in a country’s national interest. There is the infant industry argument and the optimum tariff argument. The former has had qualified support by economists from Marshall onwards, but its supporters would, in the nature of the case, not be interested in reciprocal concessions to exports. The optimum tariff argument is prominent in US literature on reciprocity. In so far as governments pursue the national interest in tariff bargaining, they are said to “see potential improvements in the terms of trade as the sole motive for departing from multilateral free trade” (Grossman-Helpman 1992, p. 1; also, in more qualified form, Baldwin 1989, p. 126, Hillman-Moser 1992, p. 1). This clearly reflects a “large-country” point of view, a country large enough (or dominant in a particular commodity market) to be able to influence its terms of trade. It is difficult to believe that even US trade policy significantly aims at improvement in the US terms of trade. US trade policy, like that of all

other countries, is primarily concerned to improve market access for its exporters and import-competing industries, often at the price of some sacrifice in its terms of trade. While one can think of cases of governments deliberately reducing the volume to improve the terms of trade – the OPEC oil price increases are a notorious example – it is doubtful whether reciprocal concessions are ever sought for optimum tariff reasons.

There are also familiar arguments for temporary protection, to counter predatory dumping or to alleviate balance of payments problems. Neither of these lends support to reciprocity as a principle of trade policy, though both often serve as ammunition for protectionists. (The balance of payment argument for protection – which influenced Keynes in 1932 – needs to be distinguished from the balance of payments argument for reciprocity which, at least in principle, can assist the cause of trade liberalisation: “For balance of payments reasons we can afford to liberalise only if you liberalise, too”.)

Clearly, none of these national-interest arguments for protectionist policies rivals voodoo economics as reinforcement of producer interests behind the principle of reciprocity.

To sum up, the conduct of trade policy, nationally and internationally, on the basis of reciprocity, exchange of “concessions”, rests on the political power of producer interests out to maintain or increase market share, but derives much of its weight from popular ignorance and prejudice. One should not exaggerate the harm it does in practice. Tariff reductions negotiated on the principle of reciprocity, as in the successive GATT rounds, are better than no reductions. But as the painfully prolonged Uruguay Round has demonstrated, they are cumbersome, slow and hedged around with exceptions and exemptions.

### Why unilateral trade liberalisation?

In the past decade, quite a few countries have unilaterally liberalised their trade, cutting tariffs and abolishing import restrictions, of their own accord, without demanding reciprocal concessions from their trade partners. How has this been possible, given the

strength of the forces which, as we have seen, have entrenched reciprocity in trade policy for over a century?

Here again, it is worth noting that the recent experience is not without historical precedent. Between 1820 and 1860 Britain moved to free trade, impelled by the confidence of its manufacturers in their competitive superiority (a confidence reinforced by the benefits of cheap food) and persuaded by the free trade advocacy of Adam Smith and Ricardo, Cobden and Bright. By the time Britain concluded the 1860 landmark treaty with France, a treaty formally based on reciprocal concessions, all she needed to offer was to continue her free trade policy (Bastable 1881). France also, under Napoleon III, a convert to free trade, for some years unilaterally liberalised her high tariffs, and there have been similar episodes in the 19th century tariff history of other countries. But it would be difficult to find significant 20th century precedents of across-the-board unilateral trade liberalisation much before the 1980s. (Trade liberalisation within the EC and other preferential trading arrangements has, it need hardly be stressed, taken place within a framework of explicit, though multi-lateral, reciprocity.)

The forces behind recent unilateral trade liberalisation are best explained by taking two conspicuous examples, Indonesia and Australia. Both countries had for decades (in Australia's case for a century) pursued an inward-looking industrialisation strategy of import substitution in a heavily protected home market, relying on their primary industries for exports. In both countries, it was the slump in commodity prices in the years 1982-85 and consequent balance of payments crisis that triggered the dramatic change of direction from import-substitution to export-orientation, opening up the economy through liberalisation of trade and financial markets. In Indonesia, the collapse of oil prices compelled the realisation that henceforth the country would have to rely increasingly on non-oil exports, *i.e.* manufactures and services. In Australia, the change of outlook which had been under way for some years was highlighted by a warning by the Treasurer (later Prime Minister), Mr Keating, that the country was in danger of becoming a "banana republic" if it allowed the drift of diminishing international competitiveness and mounting foreign debt to continue. In both countries, the political leadership, politicians and technocrats, took the initiative to embark on policies of structural adjustment largely to be effected by exposing domestic industries to international competition. But, as in Britain in

the mid-19th century, the political decisions came against the background of a notable change in the intellectual climate, internationally and nationally.

From around 1970, international organisations published evidence that the import-substitution strategy in relatively small heavily protected domestic markets was a recipe for inefficiency and stagnation (Little *et al.* 1970, Asian Development Bank 1971). Taiwan, South Korea, Hong Kong and Singapore moved towards export-oriented industrial development with spectacular success, and so in lesser degree did some other developing countries. At the same time, faith in socialism, planning and direct controls, gave way the world over to increasing willingness to rely largely on market forces for resource allocation. The decisions to embark on unilateral trade liberalisation in Indonesia, Australia and elsewhere in the 1980s were part of this process.

In Indonesia much of the impetus came from abroad, the World Bank, the IMF, the IGGI (Inter-Governmental Group for Indonesia) consortium of aid donors, and such advisers as the Harvard Institute for International Development, in interaction with Western-trained Indonesian technocrats (*cf.* Hill 1990, MacIntyre 1992). In Australia, economists outside and inside the public service, especially Corden and Rattigan, and one or two politicians, especially Bert Kelly and John Hyde, played a key role, preaching free trade and presenting arguments and evidence (*cf.* Rattigan 1986, Paul Kelly 1992).

If reciprocity in trade policy has largely reflected the pursuit of market shares by import-competing manufacturers and other producers, what interest groups have been behind the unilateral trade liberalisation? In Indonesia, private business has not until recently been identifiable as an important lobby. But there is no doubt that the large financial-commercial-industrial conglomerates (largely Chinese-Indonesian and some related to the President's family) and the Japanese and East Asian joint ventures, with their export interests and international links, now dominate the private sector. In Australia, the mining and rural lobbies which have always favoured free trade have in the past decade been joined not only by more outward-looking financial and other service-industry enterprises but also by manufacturers who have come to see the benefits of moving into foreign markets.

In both Indonesia and Australia high-cost sections of manufacturing industry continue their fight to retain protection, and in

Australia voodoo economics maintains a powerful hold on much of public opinion and parts of the media; indeed, the recent recession saw, as usual, a recrudescence of protectionism and vociferous denunciations of "economic rationalism". The battle for freer trade is never conclusively won. And while protected producer interests try to hold on to what they have – whether US manufacturers lagging in technology or motorcar manufacturers unable to hold their own without protection in Australia or Malaysia, or French and German farmers sheltering behind the Common Agricultural Policy – national trade policies will largely continue in the GATT reciprocity framework, each country jealously trading concessions for concessions. In optimistic moments, one likes to think that, as the benefits of trade liberalisation in cheaper imports and better overall economic performance come to be appreciated, the public's attachment to voodoo economics is weakening. In pessimistic moments, one may grant Bhagwati-Irwin (1987, p. 123) that "proponents of freer trade ... must come to terms with the powerful appeal of the fairness-in-trade doctrine. Without reciprocity, free trade itself would be overwhelmed politically".

But the unilateral adoption of trade liberalisation in so many countries in the Asian-Pacific region has given rise to a new approach that may achieve freer trade without the troublesome handicap of explicit reciprocity. The Asia Pacific Economic Cooperation (APEC) forum aims to encourage and promote unilateral trade liberalisation by individual member countries on a non-discriminatory (MFN) basis (Elek 1992, Garnaut-Drysdale 1994). Each member country is encouraged to liberalise its own trade, knowing that it would reap not only the benefits of freer trade to itself but also improved market access to the markets of other liberalising countries, as has indeed already happened to a considerable extent in the region. Regional economic cooperation for unilateral trade liberalisation would amount to a kind of implicit reciprocity. Whereas explicit reciprocity is liable to be inimical to freer trade since it makes liberalisation by any one country conditional on liberalisation in others which may not happen, implicit reciprocity is wholly beneficial since it takes assurance of improved market access abroad on trust. It is much to be hoped that the APEC experiment will succeed.

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