

## KEY DEVELOPED/DEVELOPING COUNTRY ISSUES INFLUENCING THE WTO AND NAFTA NEGOTIATIONS\*

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The Chinese have long had an adage about living in interesting times: “It is a curse to do so!” For people concerned about international trade, these are interesting times. Observing these interesting times does not strike me as a curse, however. To the contrary, these are absolutely fascinating times!

My perception is that we are on the cusp of a major realignment of economic and political power unlike any we have seen in a long time. This is the logical consequence of the end of the Cold War, and has long been predicted, but slow in coming forth. The realignments will probably spring from the recent developments in Europe over the Iraq issue, but extend to Russia, the Middle East, and the emerging powers of Brazil, China, and India.

Those same realignments will probably set the agenda for trade negotiations over the next decade or so. If we were smart enough to know just how those realignments were to come, we could say a lot about the key factors influencing the WTO and NAFTA negotiations in the future. Unfortunately, I do not know enough about how those realignments might evolve to be very smart about their full implications. However, I do think we need to be sensitive to those issues.

In writing my paper I encountered a persistent tension between thinking about what might be happening in the future and what I thought should be happening. I tried to resolve that tension as I moved through the exposition, but it was never resolved satisfactorily. However, one way I tried to resolve the issues was to focus on some of the broader macroeconomic issues that I believe will be major factors in the international economy, rather than the more narrow microeconomic issues that tend to dominate international trade discussions.

The discussion of trade issues between the developed and developing countries has a tendency to focus on the large subsidies the governments in the developed countries pay to their farmers and the dumping that tends to be associated with that dumping. As noted, my goal today is to broaden the agenda rather substantially as we look to the future. In doing so, I want to focus on (1) international trade as an engine of economic growth; (2) subsidies are a two-way street; (3) the source of the income distribution problem as international trade expands; (4) technology

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and trade; and (5) international cooperation and trade expansion. At the end I will have some concluding comments.

### **International Trade as an Engine of Economic Growth**

My perception is that in general we fail to recognize the significance of international trade as an engine of economic growth. One reason for that is that we tend to limit ourselves to partial equilibrium analyses in assessing the benefits of trade liberalization and thus miss many of the potential benefits of trade liberalization.

In my remarks in this section I want to focus on two significant features of trade liberalization and how they contribute to economic growth. The first set of remarks addresses the dynamic effects of trade liberalization – dynamic effects that change the underlying conditions of production. The second set of remarks focuses on the effects of trade in breaking the constraints implied by Adam Smith’s “extent of the market.”

Consider the first set of issues. Trade liberalization under a fairly general (but not all encompassing) set of conditions tends to lead to a more efficient use of resources. Probably the most general and widest set of conditions to which to refer is to think of a country that is protecting its manufacturing sector and taxing its agricultural sector (the familiar import-substituting industrialization model). Reducing or eliminating these distortions will enable the country to realize its comparative advantage and lead to a more efficient use of its resources.

An important dimension of that shift to a more efficient use of resources will be the increased competition the import-competing sectors face. The imports force a search for more competitive configurations of resources and thus a drive for efficiency. An important part of that search will probably be a search for more efficient packages of production technology – perhaps imported from abroad. With the more efficient configuration of resources and the adoption of more efficient packages of technology the sector will begin to attract savings to invest in the sector. Some of those savings may come from abroad.

As this brief analysis suggests, freer trade started a dynamic process that not only changes the underlying conditions of production in the trade sector, but also attracts more resources to the sector. Tim Kehoe has emphasized this aspect of trade liberalization in some of his work on Latin America. Even though there may not be all that much empirical evidence to support these propositions, the logic of the case seems strong.

The second set of issues involves the sectoral specialization and division of labor analyzed by Allyn Young back in 1930. Young sought to build on to the analytical framework developed by Adam Smith, but pushed the analysis beyond the division of labor and specialization among members of the labor force. Instead, he went on to the sectoral division of labor and specialization. Specialization at this level leads to external economies, and these ultimately become all encompassing.

Recall that Adam Smith noted long ago that the division of labor and specialization as he perceived it was ultimately limited by the extent of the market – by the size of the economy. If

one takes the Allyn Young perspective and puts it in the context of the international economy, there is no such limit on growth caused by the extent of the market. As long as a country is willing to specialize (not a modest IF, of course) there is no limit to its economic growth. That is an enormously uplifting idea – one that is comparable to the notion that a country can change its comparative advantage by investing in human capital.

Professor T.W. Schultz added to the positive nature of trade in this role by noting that there is no limit to the division of labor and specialization because it ultimately leads to intellectual division of labor and specialization within academia. This perspective is rooted in Frank Knight's theory of capital. Again, it is an enormously uplifting idea.

Let me conclude this section by emphasizing the powerful and pervasive forces international trade gives us in promoting economic growth. That powerfulness and pervasiveness is undoubtedly why the forces of globalization have been so strong, and so persistent.

### **Subsidies Are a Two-Way Street**

As one who spends a great deal of time in international conferences I am struck by the dominance of the complaints against the subsidies of commodity programs in the United States and the European Union. When such meetings involve representatives of developing countries, it is almost as if the developed countries are the only ones who sin when it comes to protectionism on the side of agricultural commodities.

To help us focus on the right issues, I would like to address three dimensions of this problem that have been much neglected in the past. The first is that it isn't just the developed countries that subsidize their agricultural sector through commodity programs. Dr. Gulati of the IFPRI has recently published a book in which he identifies the high level of subsidies that go to the farmer in India. Although many of these subsidies tend to be on the input side, they are no less important than the commodity market subsidies in the United States and the European Union.

Another recent study notes that Mexico also subsidizes some of its agricultural producers. The study addressed this issue in the case of maize, and noted that just as in the United States, the subsidies tended to go to the large producers. The main conclusion was that the size of the subsidy was as large as large producers in the United States receive.

My perception is that these sources of trade distortion have been neglected by trade practitioners both here and abroad. These issues deserve a great deal of attention.

A second set of issues under this rubric is the implicit subsidy to manufactured products in many developing countries. Macroeconomic policies in many of these countries have tended to discriminate against agriculture by shifting the domestic terms of trade against that sector. Those policies help keep the domestic price of food down, and given that food is a wage good, thus act as an implicit export subsidy.

To what extent have we looked at this issue? I know of no study that has looked at it empirically. Given that an over-valued currency is one of the important vehicles for

discriminating against agriculture it may be that there are no significant effects. The taxing implied by the overvalued currency may just offset the subsidy from food as a wage good. It would be nice to know, however.

Finally, I am often struck when I hear the criticisms of U.S. commodity programs at the size of our balance of trade deficits and the fact that nobody says anything about that. The significance of those deficits is that this nation imports much larger amounts from other countries than we export. In other words, we serve as a huge market for other countries. It may be that the size of that market is completely offset on the agricultural side of trade. But again, do we really know?

### **Income Distribution Problems as International Trade Expands**

One of the most prevalent arguments against globalization is that it causes the distribution of income to become more unequal or more skewed. In fact, this becomes almost an ideological argument against trade liberalization and economic integration.

I would like to make a number of points on this issue, again with the idea that we need a great deal more empirical research on these issues. The first is to note the misleading language that gets used in regard to this issue. People often say that “the rich get richer and the poor get poorer” as economic integration or globalization expands. Most of the empirical information I have seen on this issue shows that the per capita income of the more well to-do rises at a faster pace than the per capita incomes of the poor or disadvantaged, but that in absolute terms the per capita incomes of the poor does rise.

The idea that the absolute income of the poor rises as per capita income rises is an important point. Not all development policies are successful at that. We should recognize it for the positive benefit that it is.

Second, the issue then becomes why the lower income groups experience lags in their per capita incomes as economic integration proceeds. There is growing evidence on that issue as well. Much of what I have seen suggests that the problem is the lag in the educational and training system, which fails to provide the displaced members of the labor force with the new skills they need to take on the jobs in the re-configured economy. The result is a scarcity of the skills needed, and thus a shift in the relative structure of wages. That is a problem that is “fixable.” In fact, the more effectively we fix it, the more we will realize the benefits of the liberalization of trade.

Third, there is a tendency to neglect the other factors that are associated with the liberalization of trade and that might be causing some of these problems. For example, some of the employment problem might be associated with the transfer and adoption of new production technology. Recall my earlier comments to the effect that one of the dynamic effects of trade liberalization is the adoption of new production technology. That technology can indeed be labor displacing. The two effects need to be disentangled, for the policy prescriptions for dealing with them may in some cases be different.

Finally, in some economies there may be a parallel process of in-migration going on at the same time as the liberalization of trade. That immigration may also be job displacing. This is another case in which disentangling the two effects is not easy. But again, the policies to deal with these different effects might be very different.

This raises a final issue. It is well known that “trading labor” is an alternative to “trading goods and services.” In other words, policy makers can allow immigrants to enter the country and produce the good or service domestically, or they can block the immigrants and instead lower their barriers to protection. The point for our purposes is that the distribution-of-income consequences of these two approaches are quite different. How much do we know about these consequences?

### **Technology and International Trade**

Most of us realize that there is an underlying causal relationship between the adoption of new production technology and international trade. In general, the new technology makes for more efficient production, and thus to expanded international trade.

There are quite a number of issues here, however. In the first instance, whether the new technology is adopted in the production of a good or commodity whose price elasticity of demand is elastic or inelastic makes a big difference. For example, the adoption of new production technology in the production of staple goods requires the adjustment of resources out of the sector and in turn a relative income problem. The adoption of new technology in the production of a good or service for which the price elasticity of demand is greater than one will tend to increase the income to the producer and to attract additional resources to the sector. This is a vital difference, but one we encounter all too frequently in the case of agricultural trade.

Second, the way that new production technology and the investments in human capital are made can have a very significant effect on comparative advantage. A recent analysis of these issues for trade between Latin America and the United States has been very revealing. Two rather distinct processes are under way. On the one hand, the United States continues to invest rather substantially in agricultural research, while the countries in Latin America have not. In a parallel fashion, the countries sustained their investments in general education even during the economic crisis of the 1980s and the 1990s. That general education is an important ingredient in the adoption of manufacturing activities.

The interesting part of this story is that the production technology for the manufacturing sector is highly transferable, subject to the constraint implied by general education, while the production technology for the agricultural sector is not highly transferable. The result of this combination of forces is that a very significant reversal of comparative advantage is taking place between the United States and the Latin American countries. Latin America is gaining a comparative advantage in manufacturing products and the United States in the production of agricultural commodities. The implications of this are great.

Finally, under this rubric I also want to address the issue of relative resource scarcity and the adoption of new technology. This is a relatively large issue in some parts of the world, such

as Sub Saharan Africa, but important in other areas as well. The starting point for this analysis is the Hayami-Ruttan hypothesis that relative factor scarcity influences the adoption of new production technology. Their hypothesis is rooted in the experiences of Japan and the United States. Japan at one point was a land-scarce economy and therefore adopted a land-saving technology in the form of fertilizer and other biological innovations. The United States, for its part, was a labor scarce economy and therefore adopted in the beginning a labor-saving production technology.

The irony of this is that the success of the Green Revolution in Asia has caused international development agencies to try to replicate it in Sub Saharan Africa. The problem is that Sub Saharan Africa is a labor-scarce region, and the technology being produced for the region is not suited to such a resource endowment. The result is a failure to develop, and at the same time a failure to develop international trade markets.

### **International Cooperation and Trade Expansion**

There was a time when U.S. agricultural interests fought hard against the transfer of new production technology to the developing countries. The farmers knew that the new production technology could make these countries more competitive in international markets, and in fact, with them here at home. Eventually, however, our agricultural interests began to learn that the modernization of agriculture in those other countries increased their per capita income and made them a stronger market for our own exports. In effect, there was the beginning of a discovery of the division of labor and specialization.

Those lessons have not been universally learned, but they have been sufficiently learned that agricultural interests have been more complaisant of the transfer of new production to other countries. I would like to press the point a bit further, and to draw the linkages that will enable the developing countries to collaborate and cooperate with each other in such a way that they can mutually benefit.

My point is to argue that if we cooperate with scientists and technologists in the developing countries we can build a more solid base for our own economic expansion, and that cooperation will strengthen our own economic development. The benefits of such cooperation are multiple. In the first place, we develop a knowledge base on other countries and this strengthened knowledge base will help us in being more competitive. Second, we will be training our own next generation of faculty and entrepreneurs through the cooperative research we do. Third, given the strengthened position we will have in international markets, we will build a stronger basis for the assistance we provide to the other countries than we provide through our current foreign assistance programs.

We need to recognize that as we cooperate with scientists in other countries we make them more competitive, but at the same time we strengthen them as a market for our own products. One way of putting this point somewhat differently is to note that the economic integration we associate so strongly with globalization needs to be broadened by promoting this additional dimensions of economic integration.

## **Concluding Comments**

My goal in developing this paper was to motivate us to expand the perspective we take when we think about trade relations between the developing and the developed countries. That required that I move away from the micro issues that traditionally tend to dominate discussions of international trade, and shift to the broader, macroeconomic issues. The reason we need to keep this broader set of perspectives is that what we refer to as globalization is likely to continue to grow and expand. The technological revolutions that are driving the process will spread to the developing countries, where some 80 percent of the world's population resides. That means that the process of economic integration will tend to grow, and to become more complex. That underlines one of the important themes of my paper – the need for more empirical research.