After Cancun:

Possibilities for a New North-South Grand Bargain on Trade

By Thomas I. Palley | November 2003

(Editor's Note: The failure of the Cancun WTO ministerial may eventually come to be viewed as marking the end of the current global trade agenda. Given the existing lack of multilateral consensus, the immediate future promises a shift of negotiating strategy toward bilateral agreements. This shift is a transitional moment, which brings with it opportunity and risk. The opportunity is to craft an historic new progressive multilateral trade agenda based on a North-South grand bargain involving agricultural trade policy reform in return for trade-related labor and environmental standards. The risk is that bilateral negotiations could be used to weaken existing labor protections and introduce undesirable investment rules that create global lock-in. For this reason, the debates over FTAA, CAFTA, and other country agreements matter very much, since they will impact the space for future multilateral agreements. As part of its commitment to provide prescriptions as well as timely critiques of U.S. foreign policy, Foreign Policy In Focus is producing this discussion paper by economist Thomas Palley. We welcome your comments, criticisms, suggestions and responses. Please send them to FPIF co-editor John Gershman <john@irc-online.org>.)

Introduction: Who's Protectionist Now?

Even more than the failed 1999 Seattle WTO ministerial meeting, events at the failed Cancun meeting underscore the deep divisions in the debate over globalization and trade policy. Moreover, Cancun also revealed significant change in understandings of these divisions. In 1999, the Seattle protesters were widely represented by the media as "protectionist" Luddites. In Cancun, there was little talk of the protesters as protectionist, and instead the protests were framed in terms of differences over the rules to govern the global trading system. Indeed, to the extent that protectionism was raised, it was in connection with the agricultural policies of the industrialized countries.

A second major change at Cancun was the new political landscape created by the emergence of the G-21 group of developing countries. This group—led by Brazil, India, and South Africa—demanded that agricultural trade reform be a condition of any new negotiations, and they also resisted EU attempts to include multilateral investment provisions in a new round. The G-21's emergence represents a significant change in the landscape of multilateral trade negotiation. In the past, developing countries have been outgunned by the superior negotiating capacities of the EU and U.S. Now, they have shown the ability to contest agendas they find unsatisfactory. This new confidence is reflected in comments by South Africa's Trade Minister, Alec Erwin, who dismissed attempts to tar the G-21's actions as disruptive posturing:

> "There is absolutely no possibility that we merely pontificated or made political statements. The hallmark of this new group is its technical competence. I think this is a change in the quality and nature of negotiations."[1]

These two changes have important implications for what comes next for U.S. trade policy. In assessing likely developments, it is worth distinguishing between changes in *policy goals* and changes in *policy strategy*. The likely response of the administration will be one of changed negotiating strategy, and unchanged policy goals. In particular, with the G-21 unwilling to bend to EU and U.S. goals, there will likely be a shift from multilateral trade negotiations to bilateral and regional negotiations.

An alternative response is to use the opportunity provided by Cancun to craft an historic new progressive trade agenda with changed trade policy goals. What might such an agenda look like? The paper argues for a north-south grand bargain whereby developed countries reduce agricultural protections in return for trade-related labor and environmental standards. The intellectual and economic case for such a bargain is already substantially in place. The challenge is to develop the needed political support.

The Issues in Cancun: Agriculture, Investment Rules, and Intellectual Property

The dominant issue at the Cancun WTO ministerial was that of EU and U.S. agricultural policy. Both have policies that are significantly protectionist, imposing tariffs and quotas on agricultural imports. In addition, they also give production subsidies to producers. The classic example is the EU's Common Agricultural Policy (CAP), which establishes price supports that keep prices high. This causes farmers to overproduce, and the surpluses are then dumped on the global market and drive down prices. The cost of these EU export subsidies is $2.5 billion annually.[2] Meanwhile, import tariffs are needed to stop cheaper imports being attracted to European markets with their high supported prices. A second example of agricultural protection is Japan, which imposes tariffs on rice equal to 700% of production cost, thereby shutting out rice imports from Thailand.[3] A third egregious example is the U.S., which spends almost $4 billion on cotton subsidies to 25,000 cotton farmers who produce just $3 billion-worth of cotton.[4] This turns the U.S. into a major exporter, despite being a high-cost producer, and it has helped halve the world price of cotton between 1997 and 2002. The policy is especially hard on some African countries, which are heavily dependent on cotton exports for export earnings.

The total estimated value of developed country agricultural subsidies and protections is $300 billion, six times larger than total foreign aid from these countries.[5] Direct production subsidies in the EU cost around $100 billion, and in the U.S. they cost around $50 billion.[6] These policies run totally counter to the principles of free trade. Their effect is to diminish developing country access to developed country markets, while also driving down global prices of agricultural products by encouraging excess production.

A second major issue in Cancun concerned investment and government procurement rules. These rules—often referred to as the Singapore issues—deal with such issues as whether government procurement can favor domestic producers; whether governments can impose domestic manufacturing content requirements; and whether governments can impose joint venture conditions on foreign investors. The EU appears to have been especially keen to have these issues added to the negotiating agenda:

> "The EU wants rules on investment, competition policy, government purchases and customs clearance. It seems to envision the WTO as a world investment, competition and procurement organization, not just a world trade organization. Some of the proposed rules make sense on their own terms (who could be against swift customs clearance or transparent government procurement?) but they would be costly for poor countries to implement and monitor. Worse, if poor countries signed up to new obligations, then failed to fulfill them, they would be vulnerable to trade sanctions. The EU is insisting they start talking about the Singapore issues as a quid quo pro for liberalizing agriculture."
> (*The Economist*, September 12, 2003)

Developed country attempts to force these rules into the WTO raise a host of issues. First, such rules threaten to further reduce the development policy tool-kit available to developing countries. An established fact is that all industrialized countries used trade protections and government procurement practices favoring domestic business to help them industrialize. However, they now want to take these policy tools away. Professor Ha-Joon Chang (2003), of Cambridge University, calls this "kicking away the ladder." [7] Having successfully industrialized using protection and industrial policy, countries then become devout proponents of classical *laissez-faire*, arguing against the legitimacy of nationalist development policies.

The attempt to impose new investment rules as a *quid pro quo* for agricultural trade reform also highlights the nature of power at the WTO, and the problems that characterize its dealings. Historically, trade liberalization has concerned itself with rules about pricing and movement of goods between countries. Countries have been left free to design their own rules for governing domestic commerce. In

Cancun, the developing countries sought to apply fundamental free trade principles to agriculture. But instead of accepting this legitimate request, the EU (with tacit U.S. support) sought to make agricultural trade reform conditional on developing countries agreeing to new investment and government procurement rules. Such rules have nothing to do with free trade as traditionally defined, and would fundamentally impact the economic sovereignty of developing countries.

If adopted, developing countries would be unable to use policies that

1) favor domestic investors and entrepreneurs in order to build domestic production capabilities;
2) insist on domestic content provisions to encourage domestic manufacturing;
3) impose limits to foreign ownership of natural resources; and
4) require foreign investors to team with domestic producers in joint ventures.

All of these policies have been used in the past by today's industrialized nations, but now they are to be made illegal. These policy prohibitions lack any justification in terms of traditional trade theory. Instead, they constitute an attempt to impose a complex legal code that regulates ways in which countries can manage their own internal markets and commercial practices.[8]

The proposed new investment rules grow out of the same thinking that created global intellectual property (IP) rights in the Uruguay trade round that established WTO. These IP rules have become a Trojan horse, changing the agenda of trade negotiations and breaking with historic understandings of free trade. Now, the goal is to extend this new approach to cover internal rules of production.

Developing countries have suffered from IP rules on two counts. First, these countries are net importers of IP, and will be for the foreseeable future. Consequently, they are saddled with a burden of tribute to developed countries in the form of copyright and license payments. In effect, IP rules are tantamount to a tax on developing countries. Second, the WTO's IP rules bar developing countries from using the copy-cat model of development. History shows that development has often involved making knock-off products as a way of learning and joining the club. Every developed country has done this, except perhaps Britain, the first industrialized country. Now, this approach is to be off-limits.

The existing WTO IP rules are wrong on the merits. However, their inconsistency with the principles of free trade has yet to be fully understood by the public, and nor have the developing countries yet called for their full repeal. Instead, these rules have only come under public scrutiny because of the human suffering and deaths they are causing in connection with the HIV/AIDS pandemic. This is because global patent protections have served to drive up medical drug prices, putting medicines out of reach of the poor countries.

This problem has been partially addressed by a recent agreement modifying patent protections. Under WTO rules, developing countries are allowed to produce generics in cases of public health emergency. Now, small countries, that are unable to support local production, are to be allowed to import low cost generics. In order to contain the image damage done by the HIV/AIDS episode, the pharmaceutical companies have accepted this solution, subject to (i) generics only being imported in instances of public emergency, and (ii) steps being taken to prevent generics being shipped to industrialized country markets where they would undermine drug prices. The agreement gives afflicted countries access to cheaper medicine, while drug companies do give up some rights.

On the face of things this appears a fair deal. The problem is that it leaves the principle of global IP rights unchallenged. In effect, the starting premise is that the global IP rights of the pharmaceutical companies is fair and just, making it look as if the companies are generously giving away their rights. However, an alternative view is that these global IP rights should never have been conferred in the first place, and the WTO IP regime represents a fundamental violation of economic sovereignty that has no economic welfare justification. From this standpoint, the companies are giving away rights they should never have been given.

The End of Export-Led Growth: Implications for Trade Policy

The above analysis deals with the contested economic policy issues that were on the Cancun agenda. However, on top of these specific controversies, there is also growing doubt surrounding the value of trade as an engine of development. This doubt promises to further diminish the impetus for multilateral trade agreements.

The problem with the "trade as engine of development" approach is illustrated by the textile industry, and the likely developments that will follow elimination of textile quotas. Removal of quotas will drive down textile prices for the benefit of northern consumers. However, the nature of development gains for developing countries is more uncertain. One problem is that the price received for textile products will fall, and producers will no longer get the price premium resulting from the artificial restriction of supply through quotas.

A second, and potentially worse problem, is that some developing countries stand to be driven out of textile production. Under the current system, quota allocations ensure quota holders an automatic piece of the market. However, once quotas are removed, countries will lose their automatic share and they will have to compete on price. Consequently, higher cost developing countries stand to be driven out by low cost countries. In particular, there is a danger that many countries will be driven out of the market by China, which is the global low cost producer with limitless supplies of cheap labor for the foreseeable future.

The China displacement problem speaks to a broader and deeper problem with the WTO trade agenda. The push for manufacturing trade liberalization has been justified on the grounds that it stands to jump-start economic growth—an argument widely known as export-led growth. Proponents of this strategy maintain that countries benefit from specializing in the production and export of those goods in which they have comparative advantage, while contact with the forces of global competition triggers accelerated innovation, productivity, and quality improvement.

Such a process does appear to have prevailed in South East Asia, giving rise to a pattern of industrialization described as "flying geese." Initially, Taiwan, South Korea, Singapore, and Hong Kong adopted the export-led growth model. As they industrialized and absorbed their surplus labor pools, they moved into higher value-added production. Low value-added production then moved to other, more populous proximate economies such as Malaysia and Thailand.

The problem with the export-led growth model is that it suffers from a fallacy of composition. This is because exporters rely on growth of demand in export markets. When one country, or even a few, pursues export-led growth, the problem is not noticeable. However, when all adopt the strategy, there is a risk of a global shortage of demand and a supply glut.

Applied to developing countries as a group, the problem of export-led growth is manifested in the form of export displacement. Developing countries sell into northern markets. When one country tries to increase its exports, it may displace the exports of another. The U.S. market, which is the largest market in the world, clearly shows this pattern. There is strong statistical evidence that over the past fifteen years Mexican exports to the U.S. have displaced Japanese exports, and Chinese exports to the U.S. have displaced those of the four tigers—South Korea, Taiwan, Hong Kong, and Singapore.[9] Now, there is evidence that China is displacing Mexico, and jobs are leaving Mexico's maquiladora region for lower-cost China.[10]

Export-led growth is supposed to work through a process of moving up the economic ladder, with early entrants making room for later entrants. This is the backbone of the flying geese model of South East Asian industrialization. However, with China's entrance onto the world trading stage, the model no longer works. That in turn implies a need for a new economic model for global development. The implication for policy is that trade stands to take a lower place in the hierarchy of policy goals, and this in turn will further weaken an already contested trade agenda.

Is a Progressive North-South Grand Bargain on Trade Possible?

The previous sections have analyzed the issues of contention at Cancun and the economic limits of trade an engine of growth. These issues in turn inform the political landscape which can be viewed as consisting of three different interest blocs—industrialized country WTO supporters, the developing countries, and critics of the WTO system.

These three blocs hold differing positions on the issues. At Cancun, the developing countries and the critics of the WTO system joined to oppose the industrialized countries. The two issues on which they joined were agricultural trade reform and investment rules. However, this alliance has its own underlying divisions, reflecting the fact that alliances of opposition are easier to form than alliances for affirmative change.

Figure 1: Policy positions of the different interest blocs present at Cancun.

	Industrialized Countries	Developing Countries	WTO Critics
Manufacturing trade liberalization	YES	YES	MIXED-- SOME YES, SOME NO
Agricultural trade liberalization	NO	YES	YES
Investment & Procurement rules	YES	NO	NO
Global IP Rules	YES	NO	NO
Labor & environmental standards	NO	NO	YES

The nature of the disagreements is illustrated in figure 1, which shows the respective positions of the three groups. At Cancun, the industrialized countries were in favor of further manufacturing trade liberalization, retaining IP rules, and creating new investment rules. They were against agricultural trade liberalization and trade-related labor and environmental standards. The developing countries were for further manufacturing trade liberalization and agricultural trade liberalization, but against investment rules and trade-related labor and environmental standards. They were also likely against global IP rules, but this issue was not tackled head-on having been headed off by an earlier agreement on generic medicines. Finally, the WTO critics were for agricultural trade liberalization and trade-related labor and environmental standards, but against global IP and investment rules. On further manufacturing liberalization, their position is unclear. Such liberalization is difficult for manufacturing trade unions, but might be acceptable if accompanied by trade-related labor and environmental standards.

The big divide between developed and developing countries concerns agricultural trade liberalization, global IP rules, and investment rules. Contrastingly, the big divide between developing countries and WTO critics concerns trade-related labor and environmental standards.

This raises the interesting question of whether a winning trade agenda, supported by developing countries and developed country critics of the WTO, can be fashioned. Such a bargain could dramatically change the goals of U.S. trade policy and the content of multilateral trade negotiations. The key to this bargain is agricultural trade liberalization and trade-related labor and environmental standards, which if paired together might satisfy both the developing countries and the WTO critics. In addition, there may be a need to more substantively revise the WTO's intellectual property rules.

From a U.S. perspective, the critical question is whether it is possible to muster political support for agricultural trade liberalization. Agriculture holds a unique place in U.S. politics. One reason for this is the value-laden notion of the family farm which continues to cloud public understandings, and obscure the true big business nature of agriculture. A second and more important reason is the political geography embedded in the U.S. constitution, whereby each state is allocated two senate seats. This gives the relatively underpopulated agricultural states of the south and midwest tremendous political power. This power has been used to construct the current protectionist agricultural policy that benefits powerful agricultural interests in these states at the expense of U.S. consumers and developing countries.[11]

On both of these counts there is reason to believe that conditions are such that change is possible. First, it is increasingly recognized that the notion of the family farm is a misleading description of modern agriculture. Instead, farming is increasingly large-scale, and ownership resides with either corporations or extremely wealthy individuals. This pattern is matched by the distribution of farm subsidies, with the top quarter of farmers receiving 90% of total U.S. subsidies. In the EU the top quarter receive 75% of farm subsidies.[12] As a result, the rhetoric of the family farm is increasingly less politically compelling, while agricultural subsidies are increasingly viewed as a form of corporate welfare. Second, there is a growing realization that U.S. consumers in aggregate stand to gain significantly from agricultural reform, as will many developing nations. In particular, agricultural policy reform stands to lower prices, as well as reducing tax burdens by reducing agricultural subsidies.

The other side of the grand bargain requires developing countries to accept the legitimacy of trade-related labor and environmental standards. The problem here is that developing countries may object to such standards as an inappropriate *quid pro quo*, just as they rejected investment rules in Cancun. However, there are several differences between labor standards and IP and investment rules. First, whereas IP rules confer no economic development benefit on developing countries, there is a strong case that labor standards are good for development.[13] In particular, they can contribute to growth of domestic markets, and they can also stop the race to the bottom that is now being played out between southern countries—as exemplified by the movement of manufacturing jobs from Mexico to China. Second, though IP is talked of as a "right," in reality it is about discretionary domestic law and policy—i.e. choice of duration of patent and copyright protection. However, core labor standards are part of a human rights discourse, being concerned with the right of freedom of association, freedom from discrimination, freedom from exploitative child labor, and freedom from exploitative prison labor. Third, labor standards are needed because trade creates an interdependent world in which one country's practices can generate significant cross-border social and institutional effects via cross-border movement of goods. Taken together, this places labor standards in a different realm from IP and investment rules, so that labor standards do not constitute an unjustified infringement on countries' economic sovereignty.

Conclusion: End of the Road for the Existing Multilateral Trade Agenda

With its focus on further manufacturing liberalization and investment rules, the existing multilateral trade agenda has little appeal for developing countries. When linked with the new political unity of the G-21, it means the existing multilateral trade agenda is probably exhausted. The only piece of this agenda that might survive is a new global agreement restricted to just manufacturing. However, the benefits of this are limited as tariffs on manufacturing are already down, and doubts about export-led growth have undermined the case for such liberalization. In addition, a manufacturing only agreement without labor standards promises to attract the opposition of trade unions and other supporters of labor rights, as well as some opposition from remaining domestic manufacturers.

Viewed in this light, the failure of the Cancun talks provides an historic opportunity to develop an entirely new progressive multilateral trade agenda centered on agricultural trade policy and labor and environmental standards. In the immediate future, the prospect is for a shift toward bilateral and regional agreements—though even the latter will be difficult to achieve. This shift can be used for good or for bad. On one hand, the carrot of U.S. market access can be used to induce developing countries to agree to unwarranted investment rules and to weaken existing labor protections. Alternatively, it can be used to strengthen existing labor standards, thereby creating the platform that can ultimately launch the suggested new progressive multilateral agenda. For this reason, the debates over FTAA, CAFTA, and other country agreements matter very much, since they will impact the space for future multilateral agreements.

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Further Reading

Chang, H-J, Kicking Away the Ladder: Development Strategy in Historical Perspective, London: Anthem Press, 2003.

Palley, Thomas I., "Export-led Growth: Is There Any Evidence of Crowding-Out?" in Arestis et al. (eds.), Globalization, Regionalism, and Economic Activity, Cheltenham: Edward Elgar, 2003.

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——————, "The Economic Case for Labor Standards: A Layman's Guide," Journal of Global Law and Business, 2 (Fall 2001), 183-195.

Endnotes:

1 *UN Wire*, September 15, 2003.

2 "The Sword and the Shield," *The Economist*, September 12, 2003.

3 "Cancun Trade Talks an Opportunity to Lift Millions out of Poverty," *DevNews Media Center*, World Bank, September 4, 2003.

4 "The Cancun Challenge,' *The Economist*, September 6, 2003, p.59-61.

5 World Bank, *Cancun Trade Talks an Opportunity to Lift Millions out of Poverty*, September 4, 2003.

6 Ibid.

7 Ha-Joon Chang, *Kicking Away the Ladder: Development Strategy in Historical Perspective*, London: Anthem Press, 2003.

8 The argument is sometimes made that investment rules protect against inefficient corruption. There may be merit to this assertion, but that does not warrant inclusion of such sovereignty infringing rules in multilateral trade agreements. Instead, sovereign governments should remedy the problem through self-imposed improvements in governance and competition policy.

9 See Palley, T.I., "Export-led Growth: Is There Any Evidence of Crowding-Out?,' in Arestis et al. (eds.), *Globalization, Regionalism, and Economic Activity*, Cheltenham: Edward Elgar, 2003.

10 See Geri Smith, "Wasting Away: Despite SARS, Mexico is still losing export ground to China," *Business Week*, June 2, 2003, p. 42-44.

11 The success of the agriculture states in winning protection reveals the political basis of trade policy. It is interesting to contrast manufacturing and agriculture. In manufacturing, the biggest companies have gone multinational, and they have driven the manufacturing trade agenda. As a result, the interests of purely domestic manufacturing and manufacturing workers have been largely disregarded in trade policy. This contrasts sharply with the treatment of agriculture.

12 Numbers are from the Organization for Economic Cooperation and Development, as reported in "Western Farmers Fear Third World Challenge to Subsidies," *New York Times*, September 8, 2003.

13 See Palley, T.I., "The Economic Case for Labor Standards: A Layman's Guide," *Journal of Global Law and Business*, 2 (Fall 2001), 183-195.

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