



## Trade disputes, quality choice, and economic integration

Richard Chisik\*

Department of Economics, JOR-211, Ryerson University, Toronto, ON, Canada M5B 2K3

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### ABSTRACT

Recent work demonstrates the importance of developing high quality output in order to compete in export markets and other recent studies verify the prevalence of fixed and ongoing trade costs while participating in those markets. I consider the joint choice of quality and export promotion costs when trade relationships are subject to temporary disputes. When transparency is low and macroeconomic instability is high, disputes arrive more frequently and, therefore, firms may inefficiently choose lower levels of quality and export promotion. These, in turn, build shallower trading relationships with less trade volumes and higher tariffs, and generate greater trade reductions during the more common trade disputes. Several institutional features of the WTO dispute settlement mechanism that are generally lacking in preferential trade agreements such as improved transparency, dispute investigation, and the provision to recommend asymmetric continuation payoffs can ameliorate these inefficient quality choice outcomes. Hence, lower quality output and lower quality trading relationships may be more endemic to countries that depend on preferential trading areas as opposed to the WTO.

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### 1. Introduction

The importance of producing high-quality output has begun to receive serious attention in the international trade literature. One group of studies demonstrates that high-quality production is critical in fostering economic growth and development.<sup>1</sup> Another group of recent studies suggests that developing high-quality production skills is necessary for firms that export.<sup>2</sup> On the other hand, participating in those export markets requires ongoing trade and export promotion costs.<sup>3</sup> In this paper we analyze how the joint decision over export quality and the commitment to trade costs are made when trade relationships are subject to temporary disputes. Our idea is that the quality of the trading arrangement can have important and previously unrealized effects on the quality of output.

Many types of trade disputes occur inside and outside of the multi-lateral trading system (WTO) as well as in preferential trade agreements

(PTAs).<sup>4</sup> These disputes may be triggered by egregious actions (such as dumping), however, when trade policies are not perfectly transparent they may also be triggered by macroeconomic or preference fluctuations (and erroneous antidumping claims). Evidence that developing countries use antidumping actions in response to macroeconomic shocks is given by Bown (2007). The use of antidumping measures, however, is not at all limited to developing countries. The majority of dumping allegations have been made by OECD countries and as Prusa (1992, 1997, 2001), Blonigen and Bown (2003), Blonigen and Prusa (2003), and Prusa and Skeath (2004) have demonstrated, these claims are not usually triggered by dumping, however, they are facilitated by imperfect observability of the available evidence.

To develop the relationship between quality choice and trade disputes we consider a dynamic game of tariff liberalization between

<sup>4</sup> In this paper we consider trade disputes brought about by claims of unfair trade practices such as those described in Article VI of the GATT (antidumping and countervailing duties). Disputes in the present context generally do not refer to safeguards for emergency protection of a threatened industry (GATT Article XIX), exceptions for moral, health or environmental concerns (GATT Article XX), or renegotiation (GATT Article XXVIII). This distinction is relevant here because we model trade disputes as being generated by the misinterpretation of macroeconomic and preference fluctuations rather than a response to a stated change in importer policy. Antidumping claims are important for consideration because they have comprised the majority of safeguard and exceptions filed under the GATT/WTO and they are the single largest source of trade disputes. Although the number of dumping allegations reported to the WTO steadily declined from 366 in 2001 to 163 in 2007 their number increased again in the recession of 2008 and 2009 to 208 and 209 respectively.

\* Tel.: +1 416 979 5000x4620.

E-mail address: [rchisik@arts.ryerson.edu](mailto:rchisik@arts.ryerson.edu).

<sup>1</sup> See for example, Grossman and Helpman (1991), Hausman et al. (2007), and Rauch (2007). Early analyses are provided by Linder (1961) and Vernon (1966).

<sup>2</sup> Álvarez and López (2005) provide evidence for Chile, Brooks (2006) for Colombia, and Hallak (2006) for a larger group of countries.

<sup>3</sup> Roberts and Tybout (1997) and Das et al. (2007) provide evidence of these costs for Colombia. Evidence for France is provided by Eaton et al. (2006). These costs are related to the theories of export hysteresis developed by Baldwin and Krugman (1989), and Dixit (1989), and, more recently, by Alessandria et al. (2008).

two production economies with exogenous shocks that generate periodic trade wars. The cooperative level of trade barriers (as represented by an equivalent tariff) is enforced by the threat of retaliatory punitive tariffs. In addition to opportunistic behavior, however, the terms of trade is affected by macroeconomic and preference fluctuations. Even when countries do not wish to abrogate a trade agreement these external shocks can generate disputes. We consider trigger strategies as introduced by Green and Porter (1984) and adapt them to the international trade framework using the results of Abreu et al. (1990) and Fudenberg et al. (1994). Hence, exogenous shocks generate trade wars even when both countries abide by the agreement. These fluctuations are more likely to trigger disputes when non-tariff barriers are less transparent, or when countries choose not to see them clearly.

Quality choice is made by firms at the inception of the trade agreement. We assume that the incremental, and ongoing, trade, export promotion, and product development costs are related to the quality choice. In particular, higher quality products require that a higher percentage of these costs be paid in every period, even during a period of reduced export receipts, such as those that arrive during a trade dispute. Our idea is that irreversibilities arise from developing and maintaining network and sales infrastructure in the importing country, however, they may also arise from increasing output in an export sector or fitting exports to the importing country's standards.

Our first main result is that when transparency is low and macroeconomic instability is high, so that harmful trade disputes are more common, firms may inefficiently choose lower levels of quality and of export promotion in order to avoid the greater irreversibility that accompanies higher quality. We next show that the quality and irreversibility choices generated by stability and/or transparency affect the quality of the trade relationship. In particular, lower-quality more easily-reversible output generates shallower trading relationships with less trade volumes and higher tariffs. Furthermore, it generates greater trade reductions during each of the more frequently occurring trade disputes. In this way trade disputes affect not only quality choice but also the resulting level of economic integration.<sup>5</sup>

Having identified trade disputes as the source of the quality-choice economic-integration problem we next look at dispute settlement to provide a solution. The perception of unfair trade practices can be contested in several ways. First, the retaliation can proceed without notification to the WTO. For example, disputes originating in PTAs need not be notified to the WTO. Second, certain unilateral actions or the unilateral withdrawal of preferences granted under the generalized system of preferences can proceed without WTO notification.<sup>6</sup> Third, many unilateral actions (such as antidumping duties) are notified to the WTO but are not contested in the WTO. We refer to these first three groups that do not make use of the WTO's dispute settlement mechanism (DSM) as having weak dispute settlement (WDS). We contrast these three groups with the fourth group of disputes that proceed to the WTO's DSM and we refer to this fourth group as having strong dispute settlement (SDS).

Our idea is that several institutional features of the WTO's DSM that are generally lacking in PTAs or unilateral actions can ameliorate these inefficient quality choice outcomes. In the WTO a standing third-party (independent) tribunal reviews policies and claims,

<sup>5</sup> The idea that the quality of trading relationships matters has also been examined by Ben-David (2000) who shows that it is not openness per se but rather trade intensity that leads to convergence across countries. Similarly, Hoekman and Kostecki (2001) point out that poor land-locked countries surrounded by other poor countries do not see any growth from international trade.

<sup>6</sup> For example, the US Trade Representative's special 301 process investigates countries that deny protection of intellectual property or do not allow adequate market access to goods that rely on intellectual property protection. In 2001, Ukraine was found to not adequately enforce copyrights on music CDs, and the US retaliated by the selective withdrawal of preferences and the levying of prohibitive tariffs on metals, footwear and other Ukrainian imports.

makes binding rulings, and authorizes remedies. Looking at Table 1, which describes the levels of legalization in some PTAs, we see that many PTAs have no provisions for any review, rulings, or remedies.<sup>7</sup> Others only have ad hoc tribunals and in many of these cases their recommendation is not binding. Only in a precious few PTAs is the review performed by a standing tribunal that makes a binding ruling, however, even in some of these most legally developed PTAs the tribunal cannot impose remedies. In contrast to PTAs, two powerful remedies of article 22 of the WTO's dispute settlement understanding are that it sanctions selective retaliation and limits the amount of allowable retaliation.<sup>8</sup> In a similar vein, many antidumping cases begin with an arbitrary initial retaliatory tariff, which is then often countered by a retaliatory antidumping claim.<sup>9</sup> The resulting grim free-for-all is markedly different from the selective and limited retaliation administered by the WTO's DSM.

Our third main point is then that the quality of dispute settlement matters. First, the increased enforcement capability of the WTO allows it the provision to recommend targeted retaliation and temporary asymmetric continuation payoffs. These are shown here to generate quality and integration outcomes that are superior to those engendered by the symmetric trade wars evidenced in many PTAs or in antidumping and other unilateral actions.<sup>10</sup> Second, the improved transparency in the WTO reduces the frequency of disputes, which reinforces the first effect. Hence, lower quality output and lower quality trading relationships may be more endemic to countries whose trade is more concentrated within an unstable PTA, or more subject to unilateral actions. Furthermore, limited integration may help explain why many PTAs are stillborn, and many others lead to no noticeable trade creation or diversion. Even Mercosur, which is the world's largest enabling clause justified PTA, has led mostly to trade diversion of lower quality products in which the region does not have a comparative advantage (Yeats, 1998). The limited economic integration in Mercosur was well expressed as "the main rule in place within Mercosur goes something like, 'When the going gets tough, it's every country for itself.'"<sup>11</sup> A similar quality outcome occurred in the Central American Common Market (Fox, 2004).<sup>12</sup>

This paper is most closely related to the literature on the hold-up problem in international trade and that on trade agreements. Lapan (1988) was the first to recognize that the optimal tariff after production has occurred is greater than the ex-ante optimal tariff. This time inconsistency problem in tariff setting can generate lower output levels and leave both countries worse off. In McLaren (1997), factor allocation precedes a trade agreement. Because governments can

<sup>7</sup> For more on levels of legalization in PTAs see McCall Smith (2000).

<sup>8</sup> It should be noted that although the signatories to the GATT recognized the importance of effective dispute settlement in the formation of the WTO they do not extend the WTO's mediation functions to settle disputes arising in PTAs. In fact, neither Article XXIV of the GATT 1947 which allowed for the formation of PTAs, nor the 1979 Enabling Clause decision (L/4903) which reduced the rules of Article XXIV to promote PTAs among developing countries provide for any sort of dispute mediation or resolution. They reinforce this point in Paragraph 12 of article XXIV which says that PTAs should try to enforce the agreements locally. The emphasis on local (and non-WTO) enforcement was reiterated in the 1994 Uruguay Round "Understanding" on the Interpretation of Article XXIV.

<sup>9</sup> For more on the negative club effects of antidumping claims see Blonigen and Bown (2003), Blonigen and Prusa (2003), Prusa (2001), and Prusa and Skeath (2004).

<sup>10</sup> For example, recent WTO administered disputes over bananas, foreign sales corporations, and the distribution of antidumping duties on steel were settled with the dispensation of only the offended party levying retaliatory tariffs for an indeterminate, but finite, period of time. Alternatively, Mercosur's newest incarnation of the "refrigerator war" has generated escalating rounds of reciprocal tariff increases by Argentina and Brazil. This escalation has occurred with the help of a new bilateral trade dispute resolution process entitled "Mechanism of Competitive Adaptation" that allows these two countries to review their disputes in a separate non-Mercosur proceeding.

<sup>11</sup> Stated by Marcos Jank of Sao Paulo's Institute for International Trade Negotiations (Clendenning, 2004).

<sup>12</sup> An additional difference that we do not consider here is that several PTAs such as the Andean pact, CACM, COMESA, the EFTA, and NAFTA allow private individuals to file claims which certainly must increase the potential for trade disputes.

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