M.A. (ECONOMICS) PART-II **PAPER-304-305 (OPTION-I)**

SEMESTER-III **INTERNATIONAL ECONOMICS**

Unit 2

Lesson No. :

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Lesson 2.1

FREE TRADE V/S PROTECTION

2.1.1 Introduction

The commercial policy of a country is connected with a set of policy measures that have impact upon its international trade and economic relations with the other countries. Commercial Policy includes the regulations and policies that determine how a country conducts trade with other countries. It includes the use of tariffs and other trade barriers, such as restrictions on what goods can be imported or exported, and which countries are allowed to import or export goods to the home country. What should be the appropriate trade policy or commercial policy of a country? The issue was first raised by the classical authors. About two hundred years ago, the giant advocates of free trade—Adam Smith and David Ricardo—argued that free flow of goods and services, i.e., unrestricted trade, would be beneficial. As a result of free trade, each country specializes in the production in which it has a comparative advantage. This will enable each country to reap the gains from trade. After the World War II (1939-1945), commercial policy underwent a change when the wave of protectionism swept all over the world. It was argued at that time that though some trade is better than no trade, there is no reason to suppose that free trade is the best. A new question, thus, arose: Can protected trade cause a gain from trade? LDCs, by imposing tariff and duties, made an attempt to secure maximum benefits from international exchange

of commodities. But the last quarter of the 20th century saw the revival of free trade all over the globe as protection failed to provide enough gains which the countries required. International Monetary Fund (IMF) and the World Bank also pampered the free trade philosophy.

2.1.2 Meaning of Free Trade

The policy of free trade is one which does not impose any tariff or non-tariff restrictions upon free exchange of goods and services between the trading countries. Such a policy permits a country to buy and consume those goods which it either cannot produce at all or can produce only at a higher cost. Similarly it can dispose of in foreign markets, without encountering any restriction or hindrances, those products or services in the creation of which it has the comparative cost advantage. According to Adam Smith, the policy of free trade is "a system of commercial policy which draws no distinction between the domestic and foreign commodities and thus which neither impose additional burden on the latter nor grants any special favour to the former." The free trade, therefore, signifies a non-discriminatory trade policy that places no artificial barriers upon free international movement of goods and services. The essence of free trade, in the opinion of Jagdish Bhagwati, is the complete absence of restrictions upon free exchange of goods and services. Free trade, to quote him, is the complete "absence of tariffs, quotas, exchange restrictions, taxes and subsidies on production factor use and consumption."

2.1.3 Arguments for Free Trade

The philosophy of laissez faire in the field of international trade came into prominences as a reaction to Mercantilist advocacy of trade barriers. The powerful voice in support of free trade was raised by Locke, Hume and Adam Smith. A renowned line of economic thinkers, including Ricardo, J.S. Mill, Bastable, Marshall and Haberler lent strong support to the cause of free international trade. The main arguments in support of free trade are as follows :

(i) **Maximisation of world output :** If there is no tariff or non-tariff restriction upon international trade, every country is likely to specialise in the production and export of that commodity in which it has the greatest comparative advantage or the least comparative disadvantage. The benefits of specialisation and division of labour can become available to all the trading countries and they will be able to make the optimum use of their productive resources. As a consequence, the world output is likely to get maximised. When each trading country produces those commodities in the production of which it is not suited and imports those commodities which it can procure more cheaply from abroad rather than producing them itself, the real incomes of all the trading countries are likely to rise.

(ii) **Optimum use of resources :** The free trade leads not only to specialisation in production but also to factor specialisation. The diversion of all scarce productive resources to such industries where their productive efficiency is the maximum implies their

ideal or optimum utilisation. In the conditions of free trade, there is little possibility of under-utilisation or wastage of scarce resources. Any scarcity of productive factors, at the same time, can be easily off-set through their import from foreign countries. Thus free trade paves the way for the optimisation of productive factors throughout the world.

(iii) **Larger factor incomes :** In the condition of free trade, the factor units can easily and quickly move either within the same country or between different countries for securing larger remuneration for their services. It is, therefore, possible that factor incomes such as wages, rents, interests and profits are higher under free trade than otherwise.

(iv) **Optimisation of consumption :** The free international trade enables a country to import products from the cheapest market and relieve the domestic shortages of goods. It also provides opportunities for the consumer to import superior varieties of products. The increased availability of consumable goods of better varieties at low prices assures the optimasation of consumption in the trading countries.

(v) **Enlargement of market :** The absence of restrictions upon trade results in an enlargement of the size of market as every country can dispose of its surplus production in foreign markets. Products of all countries can have global demand. The extension in the size of market gives strong inducement to raise production and investment, to introduce improved techniques and to introduce new, superior and cheaper varieties of products.

(vi) **Check on monopolies :** Free trade implies free competition. The producers from different countries try to expand their sales in the markets of other countries. The price competition and introduction of newer varieties of products prevent the emergence of exploitative monopolies. In this connection, it must be pointed out that free trade does not provide a complete safeguard from monopolies. Even under free trade, there can be emergence of natural monopolies or strong local or international cartels capable of restricting output and manipulating prices.

(vii) **Educative effects :** Haberler explained that free international trade can inculcate in the population of a country such qualities as competitiveness, inventiveness, urge for excellence, efficiency, acquisition of advanced skills in production, management and organisation. These educative effects emanating from free trade make the trading countries to achieve higher production frontiers.

(viii) **Accelerated development :** Haberler has greatly emphasised upon free trade as a means for accelerating the process of economic transformation in the process of growth in different ways. Firstly, it enables the unrestricted import of raw materials and capital goods which are essential for industrial expansion. Secondly, free assists in an easy transfer of advanced technical know-how and entrepreneurship from the advanced to the less-developed countries. Thirdly, free trade facilitates large scale international capital movements to speed up the process of the growth. Fourthly, free trade promotes competition, efficiency and productivity and can create such capacities in the poor countries which enable them to achieve higher levels of production, employment and income.

2.1.4 Arguments against Free Trade

Despite strong classical advocacy of free trade, the world drifted away from free and unrestricted trade. The less-developed countries have been viewing it as an instrument of colonial exploitation. Even the advanced countries have been taking recourse to restrictions upon international trade for the realisation of their economic and trade interests. A number of theoretical and practical objections are raised against the policy of foreign trade. The main arguments against it are as follows :

(i) **Absence of pre-requisites of free trade :** The theoretical objection against the policy of free trade is that conditions necessary for it do not actually exists in the real life. Some of pre-requisites of free trade policy are perfect competition, perfect factor mobility, free working or price system and laissez faire. The absence of these requirements invalidates this policy altogether.

(ii) **Cut-throat competition :** The free international trade leads to chaotic trade conditions because the advanced countries try to capture more and more foreign markets for their products by dumping their products at very low price in other countries. This intense competition has serious destabilizing effects particularly upon the LDC's. For instance, flourishing Indian handicrafts were completely wiped out in the nineteenth century on account of relentless competition from the British manufactures.

(iii) **Lop-sided development :** Free trade underlines the specilization in production and export in those industries in case of which a given country has comparative cost advantage over others. The adoption of this principle means that other industries and sectors should remain undeveloped. These less-developed countries, which have comparative advantage in agriculture, will remain condemned as agricultural countries alone. Such lop-sided or unbalanced growth has serious economic and social consequences.

(iv) **Excessive foreign dependence :** When a country adopts a policy of free trade on the basis of the principle of comparative cost advantage, it becomes excessively depends upon the foreign country for the disposal of its production and for the import of varied products. Such an excessive dependence is detrimental to its interests both in the times of peace and war.

(v) **International transmission of fluctuations :** The free results in the transmission of prosperity or depression from one country to another. For instance, if country A is plagued by recession or depression, the fall in purchasing power of the people causes a reduction in its imports. The reduced imports signify the reduction in the exports of country B. A decline in exports of country B causes a reduction in income. Thus, the fluctuations get transmitted from one country to the other and an economic crisis assumes global proportions. The trade restrictions can effectively prevent such a possibility.

(vi) **Import of harmful products :** Where there are no restrictions upon trade, there is a danger of large inflow of harmful and sub-standard products from abroad. The unrestricted

import of such commodities is injurious for the health and efficiency of the people. It will have the effect of reducing the welfare of the society. In view of such adverse implications of free trade on social welfare function, the countries, at some stage, feel compelled to adopt restrictive measures.

(vii) **Emergence of monopolies :** The free international trade and intense foreign competition, eliminate many business firms. Consequently local monopolies or international cartels emerge. Their manipulation of supply and price to maximize profits results in the exploitation of people and hinders the free working of price system. The possibility of emergence of monopolies necessitates the imposition of restrictive measures upon trade.

(viii) **Detrimental for development :** Haberler's viewpoint that free trade stimulates development process in LDC's is difficult to be accepted by their economists and statesmen. The international exploitation of the raw materials and markets of the poor countries by the advanced countries through free trade for the last two centuries is ample evidence of the fact that it has serious adverse effects upon the growth process of the former. The development of infant industries and subsequent industrial diversification are unlikely to take place unless effective restraints upon foreign imports are enforced by the less developed countries.

In view of the reasons given above, both advanced and less developed countries have continued to drift away from the policy of unrestricted international trade since the First World War. No doubt, the international monetary and trade organisations have their avowed goal of re-establishing restriction-free trade, little success has, however, been achieved in this direction.

Self Check

1. What do you mean by free trade?
2. Do you think free trade leads to optimum utilization of resources?
3. Give two reasons against the policy of free trade.

2.1.5 Meaning of Protection

Protection refers to a commercial policy directed to protect home industries from foreign competition. Such a policy involved the imposition of import duties on the foreign products with the object of bringing the low-priced foreign products at par with the high-priced domestic import competing products. Alternatively the protection to home industries if afforded through restricting the imports either by banning them altogether or by subjecting them to import quotas and licenses. The home country may also resort to subsidization of domestic production and exports, manipulation of exchange rate and foreign exchange control. H.G. Johnson maintains that protection refers to those "policies that create a divergence between the relative prices of commodities to domestic consumers and producers and their relative prices in world markets."

2.1.6 Arguments for Protection

Several arguments are advanced to justify a policy of protection. Haberler has classified these arguments into two groups-economic and non-economic. These arguments are analysed below.

10.6.1 Economic Arguments

The principal economic arguments in support of a protectionist commercial policy are as follows :

(i) **Infant industry argument :** The most effective, accepted and sustained argument in support of protection is that a newly established industry is incapable of facing intense competition from the low-cost foreign industries in its earlier stage of development. Such an industry has to be protected from foreign competition by the state at least until it mature enough to face world competition. This argument was initiated by the writers like Alexander Hamilton, Friedrich List, J.S. Mill and Bast able and continues to muster support even in the more recent times. This argument is based upon the implied assumption that the given country has latent comparative advantage in the industry or group of industries to be protected. Only thing is that this industry or group of industries is to be given protected environment to grow upto an optimum size and become capable of achieving a high level of efficiency and consequent minimum coasts.

The argument is that the given industry has potential comparative advantage but it can not initially reap the internal economies of scale in the face of stiff foreign competition. Given protection through import duties, subsidies and provision of infra-structural and other facilities, it will be able to expand and take advantage of economies of scale and the benefits of learning by doing. The protection granted to a group of infant industries will generate external economies through the development of power, transport, communications and research. These industries have linkage with several other industries and therefore, can create a strong spin off for the whole economy. The protective duties accruing to the government can be utilised for the creation of economic and social overheads. This argument has much significance for industrial development of late-coming LDC's. It is precisely because of the growth possibilities of new or infant industries that protection has become an important feature of policy-making in LDC's.

A highly important aspect of this argument is that protection to the infant industry should only be for a short duration. As soon as they gather strength and overcome their initial cost-disadvantage, the protection should be withdrawn and these industries must be exposed to foreign competition.

Limitations : The infant industry argument suffers from certain limitations and it has been objected by the economists on various grounds. Firstly, to begin with every industry is an infant industry. It is, therefore, necessary to make a choice whether one or the other

infant industry deserves protection. There should be more rigorous test than Mill-Bastable test for making this choice. Secondly, while granting protection to infant industries, it is stated that it is to be withdrawn after a short period when industry would become able to face foreign competition. Such a criterion about the withdrawal of protection is completely vague. Thirdly, even if it is recognised that infant industry can grow through protection, yet it can not be denied that a large cluster of inefficient firms will start growing around a few efficient units behind the tariff walls. This inefficient chunk of industries will seek the perpetuation of the policy of protection, Fourthly, protection may create vested interests and the political pressure are brought upon the government to continue this policy almost indefinitely. Fifthly, protection leads to emergence of local monopolies or cartels, which corrupt the legislators and government officials for not withdrawing protection.

(ii) **Elimination of distortion argument :** It is sometimes argued that the commodity and factor markets in a country many involve certain distortions. In the commodity market, distortions may be on account of externalities in consumption and production and monopolistic or monopsonistic pricing. In the factor market, the distortions occur because of wage rigidity, wage differentials between sectors (agriculture and industry), immobility of labour between sectors, credit rationing in capital market and disequilibrium in factor markets. The presence of such distortions prevents the attainment of gains from the competitive free trade. It necessitates the policy of protection to industries not on a temporary basis as presumed in the case of infant industry argument, but on the permanent basis.

In order to analyse the effect of protective measures like tariffs and subsidies in the elimination of distortions in commodity market, it is supposed that the industry B (producing Y-commodity) responsible for a higher social cost than the private cost in the industry.

(iii) **Key industries argument:** The key industries are such industries which are of basic character. They open up the possibility of developing several other industries. The key industries include agriculture and such industries as iron and steel, heavy engineering chemicals, heavy electrical, cement, machine tools, petroleum etc. In case of these key industries or socially important industries, countries protect the domestic production even if the goods can be obtained at a lower cost from the foreign markets. In the LDC's this argument carries much weight with the development planners. It is believed that such industries must be developed at any cost as they can open the gates for industrialisation. The developing countries, through protection to basic or key industries, can hope to achieve industrial self-sufficiency in particular and economic self-sufficiency in general.

(iv) **Diversification of industries argument :** An important argument in support of protective tariff is one of diversification of industries or achievement of a proper balance among different groups of industries. The specialisation of countries in a narrow range of exports exposes them to recurrent economic fluctuations, apart from marking them excessively dependent upon the others. The unbalanced growth leads to much instability of the economy. Some factor of production, employed in the exports industries are recklessly exploited, while others are either not utilised at all or grossly under-utilised. Since

dependence on foreign countries is risky and dangerous politically and economically, all countries feel the necessity of having a balanced and self-sufficient economy through diversification in industrial production secured by enforcing protective tariff on certain categories of foreign products.

Although LDC's give much importance to this argument, yet this argument has been criticised on several grounds. Firstly, no country of the world including the U.S.A. and other highly advanced countries have natural and other productive inputs large enough to develop all the industries and achieve economic self-sufficiency. Secondly, the grant of protection for the achievement of diversification in production cuts at the root of the principle of comparative cost advantage and prevents the international specilisation. Thirdly, diversification and consequent economic self-sufficiency leads to international isolation. It is not only impossible in the modern conditions but it also self-defeating as it will saddle a country with inefficient industries, high cost and price structure.

(v) **External economies argument :** Sometimes it is argued that the imposition of tariff can facilitate the development of a large number of industries. The industrial expansion brings in external economies that provide a strong impetus to overall growth of the whole economic system. The external economies may be technological and monetary or pecuniary. The technological economies signify the impact of the use of specific techniques and factor inputs upon the output of the other firms, when the different firms are linked with one another horizontally or vertically. The pecuniary external economies arise when the profits of one firm are affected by the actions of other pecuniary external economies arise when the profits of one firm are affected by the actions of other producers. In this connection Scitovsky remarked, "....with an expansion in the capacity of an industry as a result of investment, prices of its products would fall and prices of the factor used by it could rise. The lower prices of products will benefit consumers and rising factor prices would increase the level of income of their suppliers. These are the pecuniary external benefits of economies which may result by appropriate tariff or commercial policy in the case of LDC's."

The benefit of external economies can be obtained through protective commercial policy only if the expansion of industries is planned in an integrated manner. In such a situation alone, the profitability in each one of them can be reliable index of their social desirability.

(vi) **Sunset industries argument :** A more recent argument that has emerged from the European countries is that some of their labour-intensive industries including textiles, clothing, footwear and steel have been losing competitiveness to the countries like Japan, South Korea, Taiwan, Malaysia and India since 1970's. The argument is that sun is setting on some mature industries of Europe. They can reequip themselves and regain their competitiveness only if temporary protection is granted to them. The fears were expressed that without protection there would be large scale displacement oflabour and capital from these industries. In view of this argument, tariffs were imposed upon the import of textiles, clothing, footwear etc. in a number of European countries. The sunset industries argument to tackle unemployment in those countries is guided mainly by political consideration. In

addition, once these industries are given protection, the removal of it will be extremely difficult.

(vii) **Employment argument :** A major argument in support of protective tariff since long has been the employment argument. It is certainly tempting for a country suffering from excess capacity or structural unemployment to rely upon protection to create additional jobs in the import-competing industries. As tariff is imposed, there is a reduction in imports. Consequently import-competing industries find opportunities to enlarge their scales in the home market. That assures generation of additional employment directly in such industries. The induced increase in employment may take place later in those industries which depend upon the import-competing industries as well as the import-substitution industries. Keynes offered this type of logic to justify British tariff during 1930's. Although he did not advocate it as a general case of protection, yet he recognised moderate tariff as the only way of stimulating recovery without substantially reducing foreign competition.

In this connection, a counter-argument is sometimes given. The restriction of imports from abroad causes a reduction in exports of the trading partners and consequent decline in their income. A fall in foreign incomes will have repercussion on the exports of the home countries by way of drop in exports. Such a development will result in the reduction in employment in the export industries of the tariff-imposing countries. Thus there may be no net increase in employment.

If the home country resorts to protective tariff in times of recession or contraction, the trading partners may be provoked to impose retaliatory tariff. The adoption of these beggar-my-neighbour policies by several countries is likely to reduce the volume of international trade and aggravate recession and unemployment.

(viii) **Anti-dumping argument :** The imposition of tariff has a strong justification when the foreign producers have been resorting to dumping. This practice means sales in a foreign market at a price lower than that received in the home market, after allowing transport and other charges involved in transfer. Since dumping result in the flooding of a given market with low priced foreign products, the import-competing forms are likely to be hit very hard. The protective tariff can be enforced to prohibit dumping by the foreign producers. Although the members of GATT agreed to curb such practices in 1967, yet this practice still continues.

(ix) **Balance of payments argument :** When a country is faced with the balance of payments deficits and the payments due to import of goods and services are in excess receipts from abroad, the protective tariff may assist in removing the balance of payments deficit. Tariff can restrict imports from abroad and allow the growth of import-substitution industries with in the home country. This measure may become unavoidable, if the deficit country does not possess sufficient reserves of gold or foreign exchange to adjust the payments deficit.

The neutralisation of payments deficit through protective tariffs is considered more expedient than even devaluation for certain reason. Firstly, the devaluation is likely to have more widespread effects than tariffs which are applicable to a specific commodity or group

of commodities. Secondly, devaluation is not likely to make desired impact on imports, if the demand for imports in the home country is less elastic so that rise in import price causes little reduction in payments for imports.

Tariff as a means for balance of payments adjustment is criticised on certain grounds. Firstly, the imposition of import duties and consequent reduction in the supply of imports may create inflationary situation in the home country. That may aggravate the balance of payments deficit. Secondly, tariffs cut the exports of trading partners and lower their income and employment. It amounts to a beggar-my-neighbour policy whereby the home country seeks to have gain at the cost of the foreign country. Thirdly, tariffs may have little effect on the flow of foreign products especially when the foreign country enjoys the monopoly position or the foreign products are far superior than the home produced imports substitutes. In such a situation, no improvement in balance of payments deficit can be expected through imposition of tariff. Fourthly, the tariffs are likely to result in retaliatory measures by the foreign countries. Fifthly, if in the face of tariffs, the foreign countries start providing subsides to their exportable products, the effect of tariffs will get neutralised and balance of payments situation does not get improved. Sixthly, tariff can, at the most, suppress the payments disequilibrium in the short period, they can not provide a permanent remedy to the problem of balance of payments deficit.

(x) **Terms of trade argument :** A country can bring about an improvement in its terms of trade through the imposition of protective tariff. As tariff is imposed and imports are restricted, the rate at which exports of the country are exchanged gets improved. The extent, by which the terms of trade of a country can get improved, depends upon the relative elasticities of demand and supply at home and abroad. A country, which has a relatively less elastic demand for the foreign product, is in a better position to improve its terms of trade.

(xi) **Foreign capital inflow argument :** If a country imposes high tariffs, the foreign business firms may likely to set up their branches in the tariff-imposing countries and start producing their products within these countries. Thus there can be a large flow of direct investments. In this way, they can avoid tariff restrictions and have easy access to the markets of the tariff-imposing countries. The flow of foreign capital through tariffs has taken place in some of the European countries from the U.S.A. Similarly in case of India, the foreign firms entered into collaboration agreements with Indian firms for the same reason. This benefit can be derived only if the tariff-imposing country has large domestic market. LDC's can utilise this opportunity for accelerating their growth, provided they can make the foreign capitalists to invest capital in the capital goods sectors rather than luxury or semi-luxury consumer goods sector.

(xii) **Strategic trade policy argument :** This argument emphasises that the modern high-technology industries in the fields of information technology, telecommunications, computers etc. require protection. These industries are highly capital-intensive. They involve huge expenditure on Research and Development (R & D). The degree of risk in these industries is very high. They can result in large external economies. They can open up substantial growth prospectus for the countries. In view of strategic importance of these

modern industries, they should be protected from foreign competition. The policy of protecting such industries has, however, certain shortcomings. First, it is quite difficult to specify the appropriate criteria to select the industries having large external economies. Second, for the protection and development of the strategic high-tech industries, the laying down of appropriate policies also poses much problem. Third, as many developed and developing countries will resort to protective measures, their policies will have neutralising effect and gain from protection may be very little. Fourth, the adoption of import restrictions against high-tech industries of foreign countries is likely to provoke retaliatory measures from them.

(xiii) **Revenue argument :** The policy of protective tariff is supported also on the ground that the government can obtain substantial revenues from this source. It has been a major source of revenues for the governments in the LDC's like India. It is claimed that tariffs kill two birds with one stone. They yield revenue along with providing protection against foreign competition. There is, however, a counter-argument that these two objectives of tariffs are not consistent with each other. Generally, tariffs that yield more revenues, afford less protection and vice-versa. In this regard, it must be pointed out that the revenue is not fundamental consideration for the imposition of tariff. The prime goal is that of protection, additional revenue is just a by-product. Therefore, it may be stated that tariff can provide protection plus some amount of revenues. Another relevant fact in this regard is the incidence of import duties which may be wholly or partially borne by the domestic consumers. The revenue yield from tariffs must be evaluated keeping in consideration the burden that it imposes upon the people of the home country.

(xiv) **Expansion of home market argument :** If the tariffs are imposed upon the foreign products, the flow of foreign products gets restricted and the domestic producers have the opportunity of enlarging their production. They will try to dispose of their production in the home country by reducing prices and advertising. Since there is expansion of employment in new industries, the workers have larger purchasing power. This also contributes in increasing the size of market. In this regard some objections are raised. Firstly, tariffs may enlarge the home market but that may be at the expense of foreign market. The restrictions on the imports of foreign products will attract similar restrictions upon the exports of the home country by the foreign government. Consequently, the exports are likely to decline. Secondly, in the protected home market, the producers will charge high prices and sell products of inferior quality. This is not likely to bring about the sizeable expansion in the home market.

(xv) **Factor redistribution argument :** In the over-populated less developed countries like India, the supply of labour in agriculture is so excessive that the marginal product of labour is zero. The writers like Lewis, Nurkse, Ranis and Fei and Jorgenson advocated the diversion of surplus manpower from agriculture to industries for achieving a higher rate of growth. In this context, Lewis, Myrdal and Manoilesco suggested that imposition of tariffs on the imports of industrial goods can restrict import and provide opportunities for the home industries to expand and absorb the surplus labour diverted from agriculture. Such a diversion of labour will cause an increase in the marginal productivity of labour and thus

tariffs can contribute in the growth-oriented redistribution of factors. In this connection, it must be remembered that mere imposition of tariff is unlikely to result in any large scale diversion of manpower from agricultural to non-agricultural sectors. There are several formidable economic, sociological and technical constraints upon such a redistribution of productive factors in the LDS's.

(xvi) **Bargaining or retaliation argument :** If a country finds that neighbouring countries or its trade partners have armed themselves with tariff weapons and their protective commercial policies are causing harm to its exports, it has to resort to the imposition of tariffs against the exports of other countries by way of retaliation or as a means of bargaining from equal or better position. By the threat or actual resort to tariff, it can persuade other countries to dismantle the tariff wall and permit liberal and easy flow of products.

This argument is attacked on various grounds. Firstly, the retaliatory tariff by different countries will result in the shrinkage of international trade. Secondly, the retaliatory tariff can seriously imperil the economic and political relations of the countries and undermine the hopes of greater international economic co-operation. Thirdly, the retaliatory tariff may not assure better bargaining particularly when the reciprocal demand for the products of home country by the foreign countries is rather weak. Fourthly, the vested interests in a country may be so powerful that these may not permit the reduction in tariffs. As a consequence, tariffs or threat of tariff can not serve as an effective weapon in bargaining.

(xvii) **Keeping money at home argument :** It is sometimes argued that the surplus import of foreign products involves net payments to the foreigners, which brings about an expansion in income in the other countries, while there is a leakage from circular flow of income of the home country. If imports are restricted through tariffs and goods are manufactured in the home country, both commodities and money remain at home. This argument is fallacious because of certain reasons. Firstly, the imports are to be paid by exports. If a country makes imports from abroad, it has also the opportunity to export its products. If it is able to expand its exports over and above its imports there can be a flow of money or income form foreign countries to the home country. Secondly, generally such commodities are imported as are available at lower prices in the foreign countries than in the home countries. The imports at lower prices relieve the domestic shortages and increase the real standard of consumption. Thus, gain in welfare due to imports can off-set the outflow of currency. Thirdly, if a country follows this argument that will completely eliminate the international trade.

(xviii) **Pauper labour argument :** One of the argument advanced especially in advanced countries to support protection is based upon the ground of safeguarding the interests of labour. There are generally wide differences in the wage rates in different countries. For instance, the wage rages in the U.S.A. are twice as high as those in Britain and three times that of Italy and about 15 times than that in India. In view of such wage differences, it is argued that the products of high-wage countries cannot compete with the products turned out by the low-wage countries through what is termed as the use of 'pauper' labour. Therefore, in order to shelter the living standard of workers from the competition of

pauper labour, the protective tariffs should e clamped upon the products of low-wage countries.

In the ultimate analysis, it may be stated that the pauper-labour argument has proved to be inconsistent with the actual realities. The labour-scarce countries like the U.S.A. and Britain have maintained high wages in spite of the imports of labour-intensive goods and large scale immigration of labour from the labour-abundant countries.

(xix) **Equalisation of costs argument :** The policy of protection is supported sometimes on the ground that it can bring equalisation in the costs of production of foreign and domestic products. If foreign products are cheaper by 20 percent compared with the home produced goods, the imposition of import tariff of 20 percent can equlise prices and the two countries can compete on equal terms. Tausigg considered such a tariff policy as fair. Ellaworth has refuted this argument on certain grounds. Firstly, if the cost difference is high, the protection country will have to resort to stiff dose of import duties. That will have serious adverse effect upon the volume of international trade. Secondly, the restriction on imports from abroad through trade will cause injury to the domestic export industries as they will find that the foreign markets are shut for them. Thirdly, the policy of imposing tariffs for the sake of cost equalisation is discriminatory. If the principle is applied, the home country will find itself protecting the most inefficient and sick industries with little or no protection to the most efficient industries.

(xx) **Conservation of national resources argument :** Certain countries specialise in the export of exhaustible raw materials and minerals such as coal in Britain, iron ore, manganese and mica in India, gold in South Africa and crude oil in the Middle East countries. The writers like Jevons and Patten argued that the countries exporting exhaustible natural resources like minerals should impose export tariffs for conserving them for a longer period. They can utilise these resources better by developing the manufacturing industries in the home country and exporting the manufactured products to foreign countries.

(xxi) **Economic recovery :** If a country is passing through recession or contraction, the economic recovery can be possible, it is argued, through the tariff protection. Such a line of reasoning was supported even by Keynes. According to him, for a country which is neither in equilibrium nor in sight of equilibrium, protection and not free trade is the most rational trade policy. Keynes suggestion was refuted both by Robbins and Beveridge. They expressed the fear that restrictions will be affected, is governed by the reciprocal elasticity of demand for them in foreign countries. In addition, the restriction by foreign countries can have very little effect if the home country has a large internal market. There is presently a strong lobby among the economists that supports tariffs in the event of recession or contraction.

2.1.6.2 Non-Economic Arguments

Certain non-economic arguments are advanced in support of the policy of protection. These arguments are as follows :

(i) **National defence argument :** The policy of protection is supported on the basis of the argument that a country must be self-sufficient in the matters of defence production. It is considered risky and dangerous to depend on the foreign countries for the supply of war materials. Even a strong votary of free trade like Adam Smith recognised that "defence is better than opulence". In view of the desirability of having independence from other countries in this most vital area, it is felt that the industries producing defence materials must be granted protection irrespective of cost. But the military requirements in modern times are so extensive that a developing country is not likely to achieve self-sufficiency in deference production even if it stretches its available resources to the fullest extent. Therefore, it is practical for the poor countries to strive for the maximum possible self-sufficiency in defence rather than the unattainable complete independence from the import of defence requirements. Strategywise, it is appropriate to procure the latest and more effective defence materials than producing obsolete and less effective materials at home through inefficient sheltered industries. But the security of a nation is of so paramount importance that no economic argument can cut any ice.

(ii) **Special interest argument :** In a particular country, there may be certain classes of population or occupations which are very vulnerable to foreign competition. For instance, artisans having special skills can not produce goods at costs low enough to face competition from machine-made imported products. Their interests should be protected through tariffs for the sake of preserving social ethos and national heritage. Similarly agriculture is a depressed sector in the developing countries. The farm producers, if faced competition from abroad, having to be protected, otherwise the production process in that sector is likely to get seriously disorganised. In this regard, Haberler remarked, "Agriculture is the well-spring from which the human race is physically and mentally regenerated." Therefore agriculture should be protected from foreign competition at all costs to preserve the special ethos of the nation. Not to speak of the LDC's like India, even the advanced countries of European Union and the U.S.A. have protected agriculture through sizeable subsides that resulted in the collapse of the Cancun meet of W.T.O. in September, 2003.

Self Check

1. What do you mean by policy of protection?
2. Explain the infant industry argument in favour of protection.
3. Give two non-economic arguments in favour of protection.

2.1.7 Protection and Less Developed Countries

In the LDC's the policy of protection is strongly supported because it can lead to accelerated growth. The main arguments in support of protecting the home industry in the LDC's are as follows :

(i) **Growth of Infant Industries :** As the LDC's initiate the programme of industrial development, it is necessary that newly started industries or the infant industries are protected from destructive competition from the industries of developed countries.

(ii) **Diversification of industries :** The industrialisation of the economies of LDC's can be possible only if tariff and other restrictions are imposed upon import of foreign produced goods. The cessation of the flow of foreign products allows time for expanding not only the consumer goods industries but also the intermediate goods and capital industries, export industries, import-substitution industries, agriculture-based industries and defence industries and several other industries allied to above categories of industries.

(iii) **Greater domestic capital formation :** The imposition of tariff on foreign produced luxury manufactured consumer products will reduce their consumption in LDC's. As a consequence, saving will increase. The increased saving can be employed for stepping up investment within the home countries. Alternatively, the foreign exchange conserved through import restrictions can be expended for importing capital goods. Thus, increased saving and home investment due to protection policies will step up the rate of domestic capital formation in these countries.

(iv) **Inflow of foreign capital :** When the LDC's impose import restrictions, the foreign producers, in order to escape them, decide to set up tariff factories either directly or in collaboration with the local industrialists within the LDC's. Thus, protection provides strong impetus to the inflow of foreign direct investment into the LDC's.

(v) **Increase in goverment revenues :** Custom duties constitute a significant proportion of tax revenues of the government in LDC's. The yield from direct taxes is quite low in these countries due to low levels of personal income, under-development of corporate sector, low tax coverage, existence of vast non-market sector, complicated direct tax laws, inefficient and corrupt tax administration etc. The protection to industry can make a sizeable addition to the revenues of the government.

(vi) **Improvement in TOT :** The terms of trade are often unfavourable for the LDC's. As protective tariffs are enforced on the important products, the demand for foreign products in the home market gets reduced and the TOT becomes favourable for the tariff-imposing home country.

(vii) **Redistribution of factor :** As protection is extended to industries in LDC's, imports from foreign countries get reduced and more industries find opportunities to expand and absorb the surplus labour diverted from agriculture. It causes an increase in the marginal productivity of labour in agriculture which was earlier zero or close to zero. Thus, tariff facilitates a growth-oriented redistribution of factors in the developing countries.

(viii) **Creation of external economies :** The policy of protection to industries in the LDC's create external economics such as the growth of allied and complementary industries, expansion of demand for factor inputs, increased competition among home producers, lowering of costs of indigenously produced goods, improvement in the quality of products. The external economies, generated by the policy of protection, have stimulating effect upon the overall growth of the economy.

(ix) **Enlargement of market :** When protective tariff is enforced by the home country, the imports from abroad get restricted. The home producers meet the demand for products within their country. Thus, the extent to market gets enlarged for the indigenously produced goods.

(x) **Off-setting of balance of payments deficit :** The LDC's are faced with chronic balance of payments deficit. When tariffs are imposed upon foreign products, imports become costly and imports have to curtail the imports of those products. It can lead to the off-setting of the balance of payments deficit.

This line of thinking is based upon quite strong reasoning that tariffs assist in growth of infant industries, in industrial diversification, in attracting foreign capital, in securing more revenues, in promoting factor redistribution, in enlarging the extent of market, in raising the rates of domestic saving and investment and in crating external economies.

In this connection, it must, however, be pointed out that excessive resort to protectionist policy has not led to rapid growth either in the advanced or the LDC's. On the opposite, tariffs can have adverse effect on growth for the various reasons. Firstly, the absence of competition from foreign producers leads only to accumulation of inefficiency in the industrial sector. Secondly, there is lack of capital, skilled manpower, dynamic entrepreneurship and economic and social overheads in the LDC's that keep the process of growth in general and industrial or agricultural expansion in particular completely hindered. Tariffs can not remove all these obstacles to growth. Thirdly, tariffs result in switch of demand from foreign consumer goods to home-produced consumer goods. In such a situation, it is difficult to generate more saving and raise the rate of investment. Fourthly, if the switch of demand for domestic products causes an excess demand, the country may be engulfed by inflationary pressures that impede economic growth. Fifthly, the reduction in exports, consequent upon the restraints upon the products of other countries, restricts the size of market and affects growth in an adverse manner. Sixthly, if tariffs result in increased demand for consumer goods and a rise in their prices, there may be diversion of investible resources from the capital goods to consumer goods sector causing a serious setback to the long run growth process in a developing country. Seventhly, tariffs may generate some additional revenues to the government but these may get dissipated in the provision of subsides to exports to check the contraction in exports. Eighthly, the imposition of tariffs alone can not lead to the productive utilisation of surplus manpower in the agriculture sector of the less developed economies. Ninthly, the tariffs invariably result in emergence of monopolies, high cost and inferior varieties of products which can hardly ensure steady growth in a country. Finally, the tariff generally cause a reduction in the volume of trade and the developing countries may find it difficult to get rid

of payment deficits. The persistently increasing balance of payments deficit can have serious adverse implications for growth.
The protective commercial policy has far more justification for the LDC's as they are the late-comers in development. From the point of view of these countries, the restricted international trade is certainly better than the unrestricted trade.

2.1.8 Conclusion

The classical golden age of free trade no longer exists in the world. But, free trade concept has not been abandoned since the case for free trade is strongest in the long run. Protection is a short term measure. Thus, the issue for public policy is the best reconciliation of these two perspectives so that gains from trade (may be free or restricted) become the greatest. In recent times, most of the countries are members of the World Trade Organization (WTO) which favour more free trade than restricted trade. This philosophy gathered momentum in the Dunkel Draft and General Agreement on Tariffs and Trade (GATT) negotiations. The aims of both the GATT (abolished in 1995) and now the WTO are trade liberalization rather than trade restrictions.

2.1.9 Short Answer Type Questions

(a) What do you mean by commercial policy of a country?
(b) Explain the concept of dumping.
(c) Explain the argument of expansion of home market in favour of protection.
(d) Differentiate between the policy of free trade and policy of protection.

2.1.10 Long Answer Type Questions

a) Give arguments for and against the policy of free trade.
b) Give arguments in favour of protection.
c) Explain the need for policy of protection in LDC’s.

10.11 Suggested Reading Material

(1) C.P. Kindleberger : International Economics.
(2) B.O. Soderston & Geoffrey Reed : International Economics.
(3) D.K. Salvatore : International Economics.
(4) K.C. Rana & K.N. Verma : International Economics.

Lesson No. 2.2 **Author : Dr. Ramna Singla**

Theory of Tariff and Stopler-Samuelson theorem, Partial and general equilibrium analysis

A tariff is a tax or duty levied on goods when they enter and leave the national frontier or boundary in this sense, a tariff refers to import duties and export duties. But for practical purposes, a tariff is synonymous with import duties or custom duties.

Types of Tariffs : Tariffs are classified in a number of ways.

(a) On the Basis of Purpose: Tariffs are used for two different purposes : for revenue and for protection.

1. Revenue Tariff: Revenue tariffs are meant to provide the state with revenue. Revenue duties are levied on luxury consumer goods. The lower of the import duties, the larger is the revenue from them.

2. Protective Tariff: Protective tariffs are meant "to maintain and encourage those branches of home industry protected by the duties." Now-a-days, governments levy import duties with the principal objective of discouraging imports in order to encourage domestic production of protected industry.

1. **Advolerm Duty :** It is levied as a percentage of the total value of the imported common duty. The import duty is a fixed percentage of the c.i.f. (cost, insurance and freight) value of the commodity.
2. **Specific Duty:** Specific duties are levied per physical unit of the imported commodity.
3. **Compound Duty:** Often, governments levy compound duties which are a combination of the ad valorem and the specific duties. In this case, units of an imported commodity are levied a percentage and valorem duty plus a specific duty on each unit of the commodity.
4. **(a) Sliding Scale Duty:** Sometimes governments levy import duties which vary with the prices of commodities imported. Normally, sliding scale duties are imposed on specific basis.
   (b) On the basis of country-wise discrimination. The following types of tariffs are levied on the basis of country-wise discrimination.

1. Single Column Tariff: When a uniform rate of duty is imposed on all similar commodities irrespective of the country from which they are imported, it is called single-column tariff. It is non-discriminatory tariff which is very simple and easy to design and administer.

2. Double Column Tariffs: Under this system, two different rates of duty exist for all or some of the commodities. They can be classified as follows:

(i) General and Conventional Tariffs: The general tariff is the list of tariffs which is announced by the government as its annual tariff policy at the beginning of the year. It is a particular tariff rate which is charged from all countries. On the other hand, conventional tariff rates are based on trade agreements/treaties with other countries. They may be different for different countries and vary from commodity to commodity.

(ii) Maximum and Minimum Tariffs: Governments usually fix two tariff rates for importing the same commodity from different countries. Countries with which it has a commercial agreement treaty, (under most favoured nation), minimum tariff rate is imposed. On the other hand maximum tariff rate is imposed on imports from the rest of the countries.

3. Multiple or Triple Column Tariffs: Under the multiple column tariff system, two or more tariff rates are levied on each category of commodity. But the usual practice is to have three different lists of tariffs, i.e. general, intermediate and preferential.

(c) On the Basis of Retaliation: There are two ways to levy import duties on the basis of retaliation:

1. Retaliatory Tariffs: A retaliatory tariff duty is levied by one country on the imports of another country in order to punish the latter for its trade policy which harms its exports or balance of payments position.

2. Countervailing Duty: It is an additional duty which is imposed on a commodity whose export price is reduced by the other country through an export subsidy.

Effects of Tariffs: Tariffs have a variety of effects which depend upon their power to reduce imports. The effects of a tariff may be analysed from the standpoint of the economy as a whole which is known as the general equilibrium analysis. Or they may be discussed from the point of view of a particular good or market which is known as the partial equilibrium analysis.

1. Effects of a Tariff under Partial Equilibrium: The effects of a tariff under partial equilibrium analysis relate to a small industry in a small country. When a tariff is imposed on the imports of a single commodity by a small country, it does not affect the rest of the domestic economy and also the world price of this commodity.

Its Assumptions: It is based on the following assumptions:

1. There is only one small country.
2. It imposes tariff on one commodity.
3. The demand and supply curves of a commodity relate to the country which levies an import duty.

4. These curved are assumed as given and constant.
5. On the demand side, consumers tastes, incomes and prices of other commodities are assumed to be constant.
6. On the supply side, changes in cost conditions such as externalities, technological innovations, etc. do not change.
7. The world supply of commodity is perfectly elastic with respect to price.
8. The home country does not impose tariff on the imports of materials required for producing the commodity.
9. There are no transport costs.
10. The foreign price of the commodity remains unchanged.
11. The imported and domestically produced commodity are perfect substitutes.

Eight effects of tariffs: (1) Protective Effect; (2) Consumption Effect; (3) Revenue Effect; (4) Redistributive Effect; (5) Terms of Trade Effect; (6) Competitive Effect; (7) Income Effect; and (8) Balance of Payments Effect. All these effects are the result of the Price Effect which we first explain.

(1) Price Effect: D and S are the domestic demand and supply curves of a commodity. OP represents the constant world price at which the foreign producers are prepared to sell their commodity in the domestic market. Thus the horizontal line PB's the supply curve of imports which is perfectly elastic at OP price. Thus under free trade (before the imposition of a tariff) the equilibrium market position is given by point B where the domestic demand curve D intersects the world supply curve PB at the price OP. The total demand for the commodity is OQ_3. The domestic supply is OQ. The difference between domestic demand and domestic supply is met by importing OQ_3 quantity at OP price.

Suppose a tariff of PP_1 is imposed on the import of the commodity. The domestic price of the commodity rises by the full amount of the tariff of OP_1. Thus rise in the price of the commodity by PP_1 is the price effect of the tariff. As a result, the equilibrium market position is at point N. In response to the higher price, the domestic demand falls from OQ_3 to OQ_2 and the domestic supply increases from OQ to OQ_1. So that total demand for the commodity is OQ_2 which is partly met by domestic supply OQ_1 and partially by importing Q_1Q_2. Thus imports have fallen from OQ_3 to Q_1Q_2 as a result of the price effect. The protective, consumption, revenue and redistribution effects of a tariff can also be illustrated by Fig.

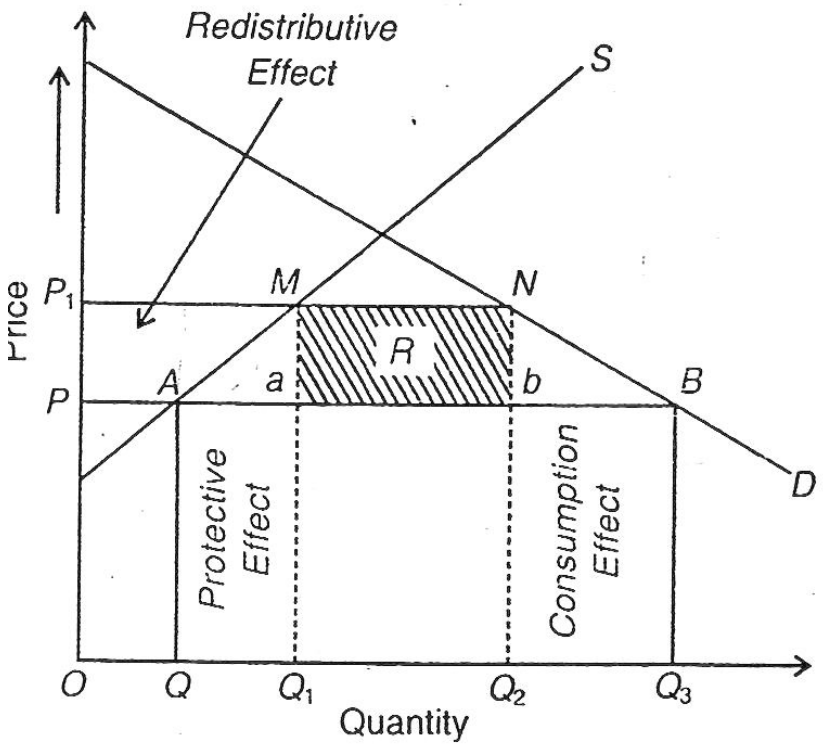


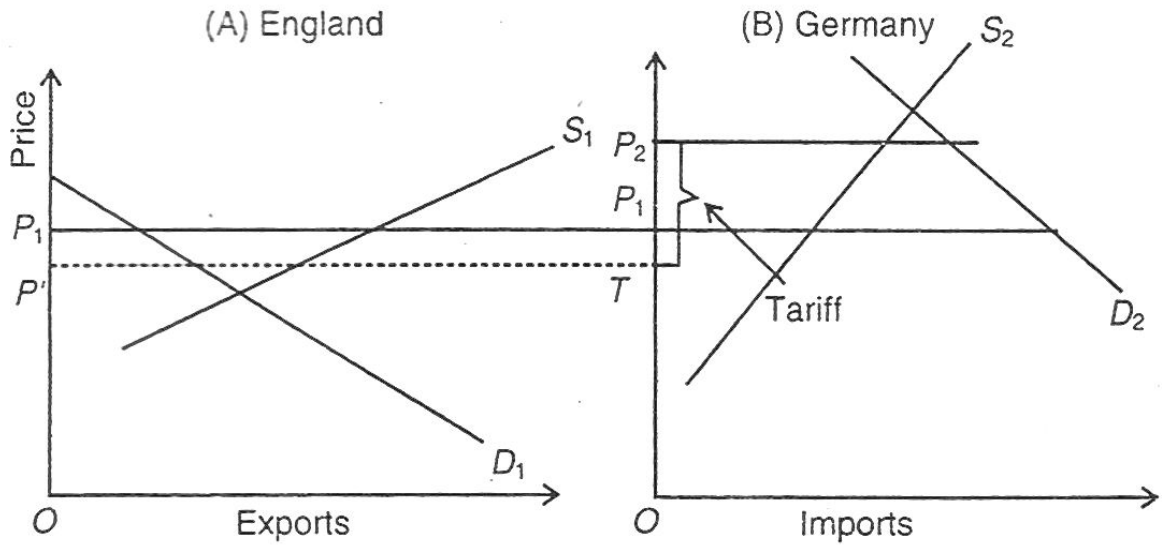
FIG. 1

1. Protective Effect: The protective effect shows how the domestic industry can be protected from foreign competition by imposing an imports duty. In Fig. under free trade, OQ_3 quantity of the commodity is imported at OP price. With the imposition of the import duty of PP_1, imports are reduced to Q_1Q_2., while the domestic production (supply) of the commodity increase from OQ to OQ_1. Thus the increase in the domestic production of the commodity by QQ_1 as a result the tariff is the protective or production effect.

2. Consumption Effect: The consumption effect of the tariff is to reduce the consumption of commodity on which the tariff is imposed. Before the imposition of a tariff, consumers were consuming OQ_3 quantity of the commodity at OP price, with the levying of an import duty of PP_1 the price of the commodities rises to OP_1. Now imports are reduced by Q_3Q_2 and the total consumption of the commodity also reduced from OQ_3 to OQ_2. Thus Q_3Q_2 (=OQ_3 – OQ_2) is the consumption effect of the tariff. This, in turn, leads to a net loss of consumers satisfaction equal to the area PP_1NB. Kindleberger calls the combined protective and consumption effect as trade effect. The impose of PP_1 tariff has the effect of reducing the total volume of trade of the country equivalent of - Q_1Q_2.

3. Revenue Effect: The revenue effect is the change in government receipts as a result of the tariff in the case illustrated in Fig initially the tariff is assumed zero at price OP. So when PP_1 import duty is levied, the revenue to the government is equal to the amount of the import duty multiplied by the quantity of imports. The revenue effect is, therefore, $PP_1 \times Q_1Q_2$, or the rectangular shaded area R.

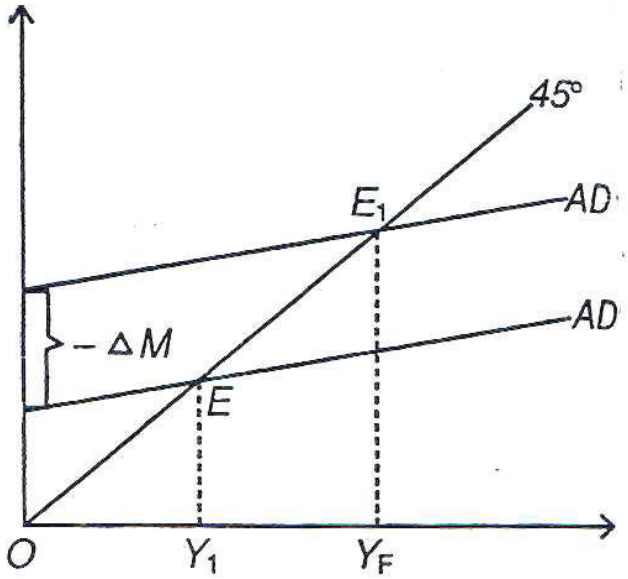
4. Redistributive Effect: The redistribution effect results from producers receiving higher price for their commodity after the imposition of the tariff. According to Kindleberger the redistribution effect is an addition to producers surplus demand by subtraction from consumers surplus.



5. Balance of Payments Effect: A tariff has a favourable balance of payments effect by reducing imports in the tariff imposing country and reducing exports in the other country. Thus a tariff reduces the country's international expenditure and brings stability in the balance of payments. The balance of payments effect is illustrated in Fig. Under free trade conditions, QQ_3 commodity is imported at OP price. The total value of imports is represented by the rectangle AQQ_3B. This represents a balance of payments deficit. To remove this deficit, PP_1 import duty is levied on the imported commodity. As a result, imports are reduced from QQ_3 to QQ_2. The government gets a revenue equal to the area R. There is also improvement in the balance of payments.

6. Income Effect: The income effect refers to the effect of a tariff on the levels of income and employment of country imposing the tariff. A tariff reduces the demand for imported goods by reducing imports, and increases the demand for home-produced goods on the assumption that there is no retaliation by the other country. It will increase the value of the

export surplus (X-M), thereby increasing the inflow of income from the foreign sector. The whole of the income diverted from imports will not be saved but a part of it will be spent at home. Under conditions of less than full employment, this will raise money and real incomes and employment.

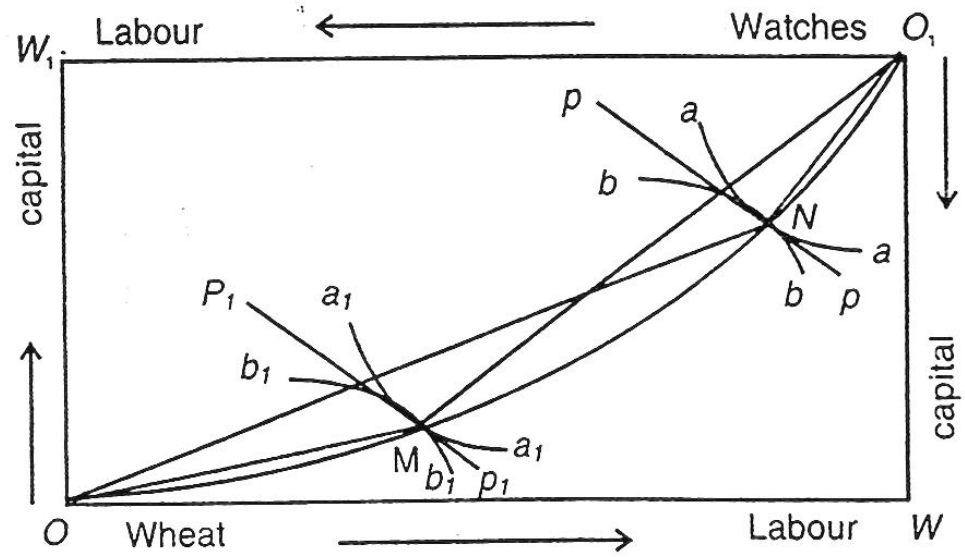


Effects of a Tariff on Income Distribution: The Stopler-Samuelson Theorem: Stopler-Samuelson showed in article in 1941 that certain restrictive assumptions, a tariff can raise both the relative and absolute income of the relatively scarce factor of production and lower that of the abundant factor. Their analysis is set in a general equilibrium framework and has come to be known as the Stopler-Samuelson Theorem.

Its Assumptions: This analysis is based on the following assumptions:

1. There are two countries which trade with each other, but the analysis is geometrically confined to the home country.
2. This country produces only two commodities wheat (W) and watches (W_1).
3. These two commodities are produced with only two factors, labour and capital.
4. Production functions of both commodities are linear and homogeneous of degree one. In other words, production takes place under constant returns to scale.
5. Both factors are fixed in supply.
6. Both factors re fully mobile.
7. Both factors are fully employed.
8. There is perfect competition in the factor and commodity markets.

9. The production of watches is relatively capital intensive and that of wheat is relatively labour intensive.
10. Labour is an abundant factor of production and capital is a scarce factor in the home country.
11. Wheat is the exportable commodity and watches are the importable commodity.
12. The terms of trade between the two countries remain unchanged.

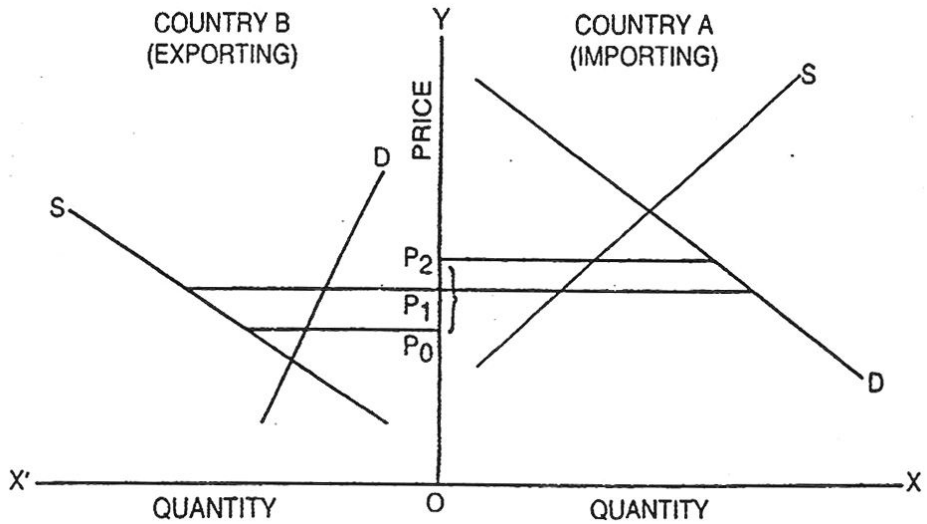


Explanation: Given these assumptions, the effect of imposition of a tariff by the home country on income distribution is illustrated in Fig. Assuming that the home country exports the labour-intensive commodity wheat and imports the capital-intensive commodity watches, the origin of wheat production is shown as O and that of watch production O_1 so that OO_1 is the contract curve *aa* is the isoquant of wheat and *bb* that of watches. They are tangent to each other at point N on the factor price line pp under free trade. When a tariff is imposed on the capital intensive watch-imports, their domestic price rise and their imports decline. The country produces more watches and less wheat. This leads to the diversion of capital and labour from whet production to watch production. This is shown by the shifting of the isoquant *aa* of wheat downward to a_1a_1 and of the isoquant of wathces *bb* upward to b_1b_1. The new production points is *M* where the two isoquant a_1a_1 and b_1b_1 are tangent at the factor price line p_1p_1. Since watches are capital intensive, the relative demand for capital rises.

There being perfect factor mobility within the country, both capital and labour will move into the watch industry from the wheat industry. But the demand for capital will be greater than that of labour because watches are relatively more capital intensive. This tends to bid up the relative price of capital. This leads to the substitution in both industries of labour for capital. It means that the capital-labour ratio falls in the production of both commodities. This is shown by the less steep slope of the factor price line p_1p_1 as against the *pp* line before the imposition of the tariff.

The conclusion emerges that as the country moves from point N to M with the imposition of a tariff, its national income is lowered. The return to the scarce factor capital increases and the wage of the abundant factor labour falls in both relative and absolute terms with the reallocation of resources.

(v) Terms of trade effect: The traditional theorists believed that tariff led to an improvement in the terms of trade of the tariff-imposing countries. The modern theorist, however, do not hold such a simplistic view. In their opinion, the terms of trade, consequent upon the imposition of tariff, depend upon the elasticity of demand and supply of products of the two trading countries. If the foreign supply of a good is perfectly elastic or if the foreign suppliers are ready to supply the product at a constant price, the imposition of tariff is not likely to improve the terms of trade for the tariff-imposing country. In case the foreign supply of a good is not perfectly elastic, the imposition of tariff can have varying effects upon the terms of trade of the tariff-imposing country depending upon the elasticity of demand and supply in the two trading countries explained in figure.



In Fig. country A is an importing and country B is an exporting country. The domestic demand and supply curves of the exporting country B are

less elastic. Country B imposes per unit tariff of P_0P_2 amount for reducing import of the commodity. Since the domestic demand is inelastic, the surplus product of country B can be disposed of in the other country A. Therefore, the exporters lower the price of the commodity of P_0P_2. So P_0 P_1 part of tariff is borne by exporters and P_1 P_2 part of it by the importers. If the tariff burden borne by importers in country A is less than the burden borne by the exporters i.e., $P_1 P_2 < P_1 P_0$, the rise in price of the commodity in country A is less than the fall in the exports price of the commodity in country B. In such a situation, the terms of trade become favourable to the tariff-imposing country.

VI. COMPETITIVE EFFECT

The imposition of tariff, can facilitate the growth of an infant industry which otherwise is not in a position to face the foreign competition. As tariff makes the foreign product relatively more costly, the domestic infant industry finds opportunity to grow behind the protective shield. Thus tariff increases the competitive power of the industries of tariff-imposing country.

VI. General Equilibrium Analysis of Tariff in a Small Country: When the tariff-imposing country is small, the domestic price of the importable commodity will rise by the full amount of tariff for the individual consumers and producers in that small tariff-imposing country.

Assumptions :

(i) The trade takes place between two countries – A and B.

(ii) The home country A is small.

(iii) There are two commodities, cloth and steel, being exchanged between them.

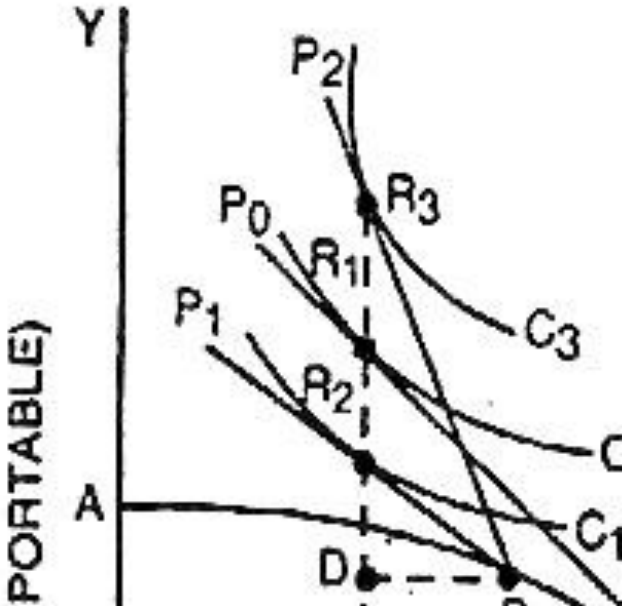
(iv) Cloth is exportable and steel is importable commodity.

(v) The imposition of tariff by A upon importable commodity steel raises the import price of steel for domestic producers and consumers upto the full amount of tariff.

(vi) World price of steel remains unaffected.

(vii) The revenues collected by the government through tariff are spent by the government to subsidies public consumption such as schools, health services etc.

The production and consumption effects of tariff upon country A can be analysed through



In Fig. the production possibility curve related to two commodities cloth and steel is AA_1. In the absence of international trade, the point of consumption and production equilibrium is B. In the conditions of free international trade, P_0 P_0, is the international exchange ratio line and the production equilibrium point is E. The consumption equilibrium point is R_1 that lies on the community indifference curve C_2. In this situation, country exports FE quantity of cloth and imports R_1F quantity of steel. If tariff is imposed but the world prices of commodities remain the same, the international exchange ratio line is P_1B. Now production equilibrium shifts to

B where country A produces a large quantity of steel (importable good) domestically. This is the production or protective effect of tariff. The consumption equilibrium shifts from R_1 to R_2. It shows that tariff has caused a reduction in the welfare of tariff-imposing small country. The shift in consumption point from R_1 to R_2 signified the consumption effect of tariff.

Thus in the case of small tariff-imposing country, the import has adverse effects, Firstly, since world prices of exchanged commodities remain unchanged, tariff has adverse effects. Firstly, since world prices of exchanged commodities remain unchanged, tariff fails to bring about an improvement in the terms of trade for the home country A. Secondly, although there is an increased production of import-substitutes within the home country yet the diversion of resources from the production of cloth, shows he misallocation of resources and consequent loss to country A.

Thirdly, the shift of consumption equilibrium to a lower community indifference curve indicates loss in welfare for the tariff-imposing country. Fourthly, tariff not only reduced imports but also the exports of the tariff-imposing country.

II. General Equilibrium Analysis of Tariff in a Large Country: If the tariff-imposing country is large, the reduced demand for imports subsequent upon the imposition of tariff may reduce the world demand for the product to such a great extent that the price of importable good falls. In such a situation, the fall in import price relative to export price causes a change in the international price ratio and brings about an improvement in the terms of trade of the tariff-imposing large country.

The production effect, consumption effect and terms of trade effect due to tariff can be explained through Fig.

A is better off because of positive consumption and terms of trade effects. The shift to consumption equilibrium to the highest community indifference curve C_3 signifies a gain in welfare despite reduction in specialization and diversion of resources towards the production of import-substitute. This is the positive consumption effect.

The Theory of Optimum Tariffs: It is, of course, true that tariff, in certain situations may fail to improve the terms of trade of a given country. This leads to a vital question. viz., to what extent a country can go on increasing tariffs, improve its terms of trade and maximise the economic welfare.

Tariffs result in gain for the tariff-imposing home country in the form of improvement in the terms of trade. At the same time, tariffs involve cost in the form of reduction in the volume of exports and imports.

In case the cost of tariffs for the society is more than the gain from tariffs, there may be reduction in the level of economic welfare and the worsening of the terms of trade. In such a situation, it is appropriate for the tariff-imposing country to reduce tariff. The point of optimum tariff is reached when tariff does not further increase the net benefit to the given country and a level of economic welfare has become maximum.

The point of optimum tariffs is determined when the trade indifference curve of the tariff-imposing home country becomes tangent to the offer curve of the foreign country. This can be shown through

In Fig. originally OA is the offer curve of home country A and OB is the offer curve of foreign country B. T_1, T_2 and T_3 are the trade indifference curves of country A. Before the imposition of tariff, the exchange takes place at P. This point lies on the trade indifference curve T_1. As tariff is imposed, the offer curve of country A shifts to OA_1 and exchange takes place at P_1. This point occurs at the higher trade indifference curve T_2. Thus tariff results in an improvement in terms of trade, on the one hand, and increases the level of welfare on the other. If there is a further increase in tariff. Country A's offer curve shifts to OA_2 and given the offer curve OB of country B, the exchange takes place at P_2. This point occurs at the higher trade indifference curve T_3. Compared with point P_1 there is a further improvement in the terms of trade and increase also in the level of welfare. In case, country A raises the tariff still further, its offer curve shifts to the left to OA_3. Exchange takes place now at P_3. This point shows that terms of trade improve further but this point lies on a lower trade indifference curve T_2. Although the terms of trade in this situation improve, yet there is worsening in respect of the level of welfare. Thus P_2. is the point of optimum tariff which corresponds with the maximisation of welfare.

The Optimum Tariff Formula:- Kindelberger has stated the formula for optimum tariff in the following form:

$$To = \frac{1}{C-1}$$

Here T_O denotes the optimum rate of tariff and e stands for the elasticity of the offer curve of the foreign country at the specific point.

The coefficient e or the elasticity of offer curve can be measured is below :

$$e = \frac{-(\text{\% Change in Imports})}{(\text{\% Change in Exports}) - (\text{\% Change in Imports})} - 1$$

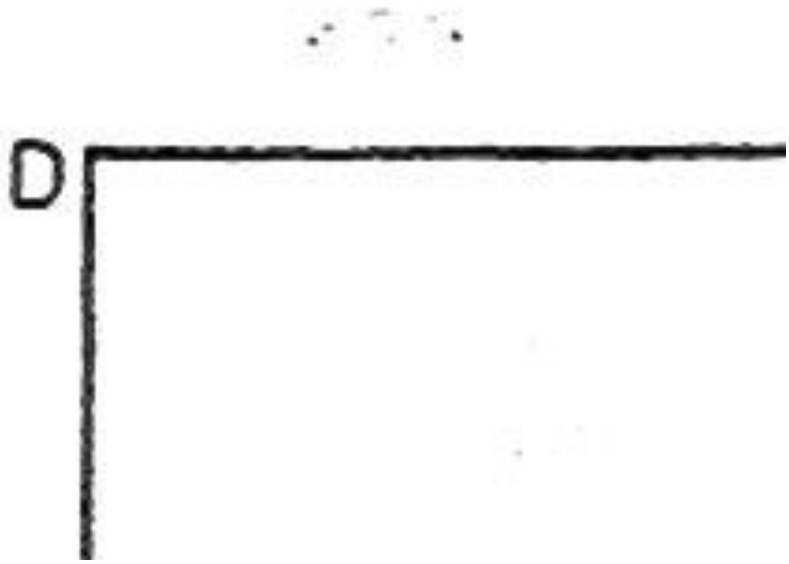
Stopler-Samuelson theorem, Partial and general equilibrium analysis :- The Stopler-Samuelson Theorem dealt with the change in income distribution on account of international trade. These writers stated that free or unrestricted international trade would benefit the relatively abundant factor and hurt the relatively scarce factor. However, if tariff were imposed upon the imports from abroad, the theorem gave the generalization quite opposite to the one given in the conditions of free international trade. According to it, the imposition of tariff would raise the real return to the nation's scarce factor in the both absolute and relative terms whereas the relatively abundant factor would suffer.

Assumptions:- The analysis related to the effect of tariff upon income distribution, according to this theorem, rests upon the assumptions given below :

(i) Trade takes place between two countries-the home country A and foreign country B.
(ii) The analysis is attempted from the point of view of home country A.
(iii) The trade is connected with two commodities-cloth and steel.
(iv) Production of these two commodities involves only two factors of production-labour and capital.
(v) Both the productive factors are fully employed.
(vi) There are perfectly competitive conditions in both commodity and factor markets.
(vii) The production function is the first-degree linear homogeneous production function. It implies that production is governed by constant returns to scale.
(viii) Cloth is labour-intensive, while steel is capital-intensive.
(ix) The supplies of two factors-labour and capital are fixed.
(x) Labour is the abundant and capital is the scarce factor in the home country.
(xi) Cloth is exportable commodity and steel is importable commodity for the home country A.

(xii) The terms of trade between two countries are fixed.

Given the above theoretical structure, the effect of imposition of tariff by the home country upon the income distribution is analysed with the help of the following figure:-



In Fig. labour is measured along the horizontal scale whereas capital is measured along the vertical scale. A is origin for the commodity cloth and C is the origin for the commodity steel. AC is the non-linear contract curve. The free trade equilibrium sutation is R where the isoquant for cloth C_2 and the isoquant for steel S1 are tangent to the factor price line P_0 P_0.

K-L Ratio in cloth at R = Slope of Line AR = Tanα

K-L Ratio in steel at R = Slope of Line CR = Tan β

If country A imposes tariff on importable commodity steel, its domestic price rises. It will discourage import of steel from abroad and induce the home producers to expand the output of steel domestically. It will necessitate the diversion of productive resources from the production of cloth to the production of steel. Consequently, production of cloth falls while that the steel rises. According to Fig., R_1 the new trade equilibrium after the equilibrium after the imposition of tariff takes place at R_1 where isoquant C_1 of cloth and S_2 of steel becomes tangent to the new factor price line P_1P_1.

K-L Ratio in cloth at R_1 = Slope of Line AR1= Tanα_1

K-L Ratio in steel at R_1 = Slope of Line CR_1 = Tan β_1

Since Tan α_1 < and Tan α and Tan β_1 < Tan β, there is a fall in K-L ratio in both cloth and steel. Although there is a fall in the K-L ratio in both the commodities, duet the price of scarce factor capital will rise relative to that of the abundant factor labour. Since there is increased production of capital intensive commodity steel, the demand for steel rises. Even though reduced output of cloth will release capital to be absorbed in the steel industry, the cloth industry being labour-intensive, the quantity of capital released by it falls short of the additional requirement of it in the steel industry. As a consequence, the return on the scarce factor capital rises while the wage rate of labour, the abundant factor falls. This is also indicated by less steep slope of the factor price line P_1P_1 after the imposition of tariff. It therefore, follows that tariff is likely to benefit the scarce factor and hurt the abundant factor. It implies that the distribution of income is likely to become more inequitable subsequent to the imposition of tariff.

Criticism of the theorem : The writers like L.A. Metzler, K. Lancaster, BO. Sodersten and J.Bhagwati on the following grounds :-

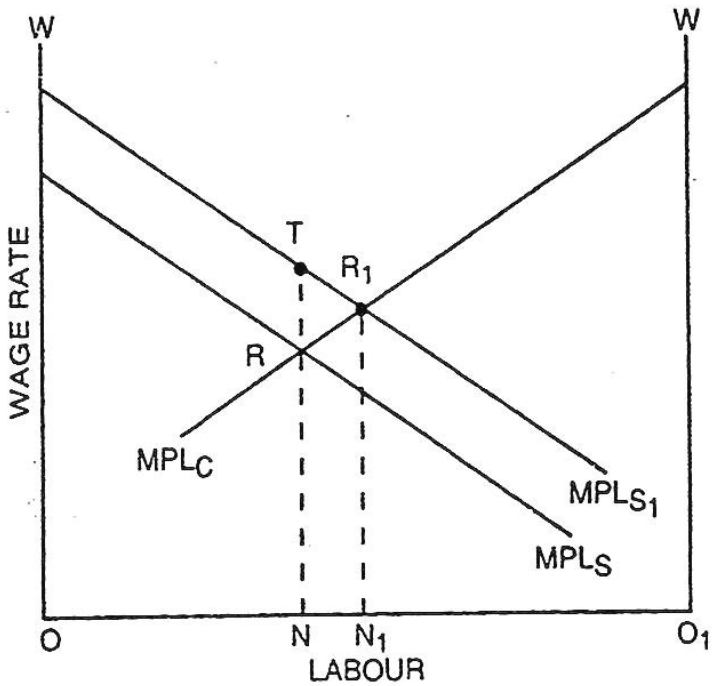
(i) Neglect of change in terms of trade : Stopler-Samuelson theorem took the assumption that tariff leaves the terms of trade unchanged. But the imposition of tariff often leads to an improvement in terms of trade for the tariff-imposing country. If imposition of tariff leads to an improvement in terms of trade and the export price to import price ratio rises, tariff will make income distribution more equitable and consequently, the Stopler-Samuelson theorem will stand refuted.

(ii) Neglect of consumption pattern: The inequitable distribution of income after the imposition of tariff has been refuted by K.Lancaster.[8] According to him, the Stopler-Samuelson theory gave that conclusion because of the neglect of consumption pattern of the people in the tariff-imposing country. They may be strongly biased towards the consumption of labour-intensive commodity and make larger import of it.

(iii) Not Universally Valid Generalizations : The conclusion given by Stopler-Samuelson theorem about the effect of tariff or protection has been attacked by Jagdish Bhagwati as not a universally valid generalization. According to him, there can be three alternative formulations of Stopler-Samuelson theorem. The first formulation is termed as Restrictive Stopler-Samuelson Theorem. It is confined to the case of a prohibitive tariff and excludes non-prohibitive tariff. The second formulation is referred as General Stopler-Samuelson Theorem. It considers both prohibitive and non-prohibitive tariff. The third formulation, called as *Stopler-Samuelson-Metzler-Lacaster Theorem* gives the conclusion that protection (probihitive

or otherwise) will raise the real wage of the factor in which the imported commodity is relatively more intensive.

(iv) Neglect of Short run effect of tariff : The Stopler-Samuelson theorem considers the long run effect of tariff on income distribution, when all factors are mobile between the nation's industries. In the short run, it is possible that labour is mobile but some capital is specific to the production of source product. If the home country A is abundant in labour and scarce in capital, the imposition of tariff, given that some capital is specific to products, the real wage is likely to fall in terms of tariff-ridden product steel and to rise in terms of the another commodity. These results are in contradiction to the Stopler-Samuelson Theorem.



(v) Possibility of factor price equalization : The Stopler-Samuelson theorem ignored the effect of tariff upon inflow of factor. If there is inflow of the scarce factor, there can be possibility of equalisation of factor prices and the redistributive effect of tariff upon income, as supposed by Stopler and Stopler and Samuelson, may fail to take place.

(vi) Empirically not valid: The Stopler-Samuelson theorem has not been supported by empirical studies. Some of the prominent studies in the area have been made by the writers like Stephen Magee. William Brock, Cairnes and John Fruend etc.

Effective Rate of Protection

The concept of effective rate of protection has been defined by Balassa in these words: "Under the usual assumptions of international immobility of labour and capital, the effective rate of duty will indicate the degree of protection of the value added in the manufacturing process." In other words, the effective rate of tariff establishes a relationship between the tariff and the domestic value added. Such a tariff rate can be a true measure of the actual rate of protection that the nominal tariff affords to the domestic import-competing industries.

Assumptions :

(i) Constancy of physical input-output co-efficients.
(ii) The primary inputs are available in fixed quantities.
(iii) The primary inputs are immobile between the countries.
(iv) Infinite elasticity co-efficients related to demand for all exports and supply of all imports.
(v) Trade takes place in case of all the inputs.
(vi) The economic system is maintained in the state of full employment.
(vii) Now-discrimination passes of all tariffs and other measures like taxes or subsidies are applied on a non-discriminatory basis.
(viii) All tradable goods continue to remain tradable.

The nominal tariff rate can be expressed through the following formula:

$$h = \frac{P^1 - P}{P}$$

Where *h* is the nominal tariff rate. P is the world price in the absence of tariff and P' is the domestic price of the final commodity including tariff.

The effective rate of protection, on the other hand, is measured by the following expression

$$g = \frac{V^1 - V}{V}$$

where g is the effective rate of protection. V is the domestic value added under free trade and V' i the value added after duty is imposed.

If there is only one imported input, the above expression can be given in the following simpler form:

$$g = \frac{t^1 - at^1}{1 - a}$$

here *t'* is the tariff rate on the given imported input. The formula given above shows that the rate of effective protection (g) does not depend only upon the nominal rate of tariff (t) but also upon the proportion of

imported input cost in the total cost of producing the commodity (a) and the tariff rate imposed on the imported input (t').

The relationship between the nominal rate of tariff and the effective rate of tariff can be explained clearly through the following hypothetical values.

(i) If t = 0.25, a = 0.67 or 2/3 and t' = 0

$$g = g = \frac{t^1 - at^1}{1-a} = \frac{0.25 - \frac{2}{3}\times 0}{1-2/3} = \frac{0.25-0}{1/3}$$

= 0.25 × 3 = 0.75 or (75 per cent)

(ii) If t = 0.25, a = 0.67 or 2/3 and t' = .15 (or 15 percent)

$$g = \frac{t^1 - at^1}{1-a} = \frac{0.25 - \frac{2}{3}\times .15}{1-2/3} = \frac{0.25-.10}{1/3} = \frac{.15}{1/3}$$

= .15 x 3 = .45 (or 45 percent)

It means the imposition of tariff on the imported inputs reduces the effective rate of production from 75 percent to 45 percent.

(iii) If t = 0.25, a = 0.67 or 2/3 and t' = 0.25

$$g = \frac{t^1 - at^1}{1-a} = \frac{0.25 - \frac{2}{3}\times 0.25}{1-2/3} = \frac{0.25 - \frac{.50}{3}}{1/3}$$

$$= = \frac{0.25}{3}\times 3 = 0.25 \text{ (25 percent)}$$

It signifies that the effective rate of tariff is exactly equal to the nominal rate of tariff, if t' = t.

(iv) If t = 0.25, a = 0.67 or 2/3 and t' = 0.30

$$g = \frac{t^1 - at^1}{1-a} = \frac{0.25 - \frac{2}{3}\times 0.30}{1-2/3} = \frac{0.25-0.20}{1/3}$$

= .05 x 3 = .15 (or 15 percent)

In this case, $t' > t$ and the effective rate of tariff (g) falls short of the nominal rate of tariff.

(v) If all the inputs are locally produced such that a = 0, then the effective rate of tariff is exactly equal to the nominal rate of tariff, i.e. (g = t)

Now suppose t = 0.25, a = 0 and t' = 0.30

$$g = \frac{t^1 - at^1}{1-a} = \frac{0.25 - 0\times 0.30}{1-0}$$

= 0.25 (or 25 percent)

(vi) If t = at', then the effective rate of protection will be equal to zero. Suppose t = 0.25, a = 2/3 and t' = 37.5 percent or 3/8, then

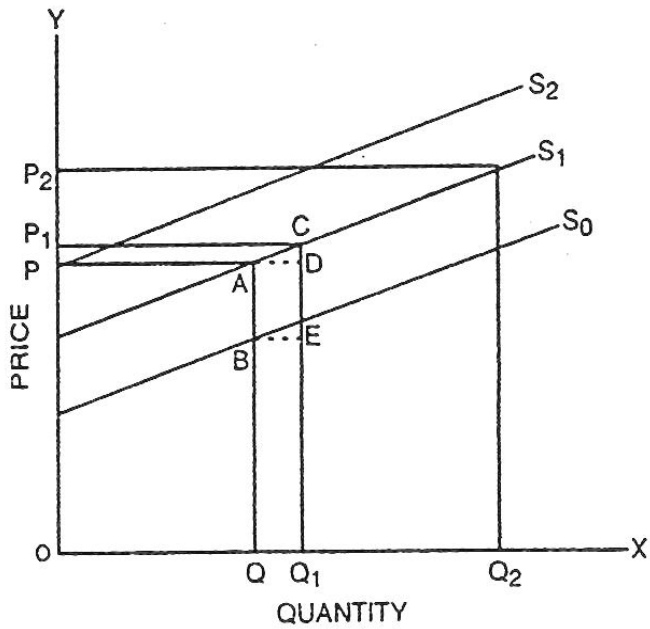
$$g = \frac{t^1 - at^1}{1-a} = \frac{0.25 - \frac{2}{3} \times \frac{3}{8}}{1-2/3} = \frac{0.25 - \frac{1}{4}}{1/3} = 0$$

(vii) If t < at', the effective rate of protection will become negative. Suppose t = 0.25, a =2/3 and t' = 45 percent or 0.45

$$\text{Then } g = \frac{t - at'}{1-a} = \frac{0.25 - \frac{2}{3} \times 0.45}{1-2/3} = \frac{0.25 - 0.30}{1/3}$$

$$= \frac{-0.5}{1/3} = 0.5 \times 3 = -.15 \text{ (or } -15 \text{ percent)}$$

The effective rate of protection can also be determined diagrammatically as shown through Fig. Since the demand is not supposed to be affected by tariff, it has not been shown.



In Fig. S_1 is the supply curve of the final product machine and S_0 is the supply curve of labour. AQ or OP is the constant free trade international price of the machine and OQ is the input of labour employed. The unit value added is measured by BQ/AQ. As tariff is imposed upon the imported machine, its domestic price rises from OP to OP_2 and the domestic production of machine expands form OQ to OQ_2. If an additional tariff is levied upon the imported inputs of this commodity, the supply curve shifts up from S_1 to S_2. Consequently, the production of machine

contracts from OQ_2 to OQ_1. However, there is a net increase in production to the extent of QQ_1. This is on account of PP_1 which is the difference between the increase in the domestic price (PP_2) and increase in the unit cost of production (P_1P_2), i.e., $PP_1 = PP_2 - P_1P_2$. The effective rate of production (g) is measured by dividing PP_1 by the value added or the contribution of the primary factor. Therefore,

$$g = \frac{PP_1}{BQ} = \frac{CD}{EQ_1}$$

(i) Importance for producers: While the concept of nominal rate of tariff is important from the point of view of the consumers because of their concern with the rise in the price of the final product after tariff, the concept of effective rate of protection or tariff has significance from the viewpoint of the producers.

(ii) Impact on resource allocation: It can not be controverted that the tariff structure can affect the direction of resource allocation to discover the resource allocation effects of a tariff structure, one must calculate the protective rate for each activity, that is the effective protective rate.

The concept of effective rate of protection also sheds light upon the nature of tariff structure in a country. A widely observed feature of tariff structure in many a country is that the nominal rates tend to be low or even zero for raw materials and rise to escalate with the degree of processing. For instance, the nominal tariff rates may be the lowest in the case of raw cotton but may tend higher and higher in case of yarn, cloth and apparels respectively.

(iv) Expansion of trade: The concept of effective rate of protection signifies that a reduction in nominal rates of tariff on the imported raw materials needed for the domestic processing seems to be a concession for the foreign country intended to expand the volume of trade.

It suggests that the countries need not impose high nominal tariff rates for protecting their infant industries. A significantly higher rate of protection can be achieved by lowering down the structure of tariff rates on intermediate products to be used in the infant industry.

Any exchange rate, official or market rate, assumed as a base rate may initially be taken. Then all exchange rates applicable to imports and exports may be converted into nominal tariff rates, import subsidies, export taxes or export subsidies.

This concept can be employed also for analyzing the effects of foreign tariff upon the trade and growth of the home country and necessary actions that can be taken for off-setting any adverse effect of the foreign tariffs.

The concept of effective rate of protection has crucial importance in this respect. The tariff policies are so devised to achieve the desired effects upon the domestic industries.

Limitations: The theory of effective rate of protection has criticism theoretical and practical limitations, which are pointed out below:

(i) Faulty and restrictive assumptions: The concept of effective rate of protection rests upon a series of faulty, restrictive and unrealistic assumptions.

(ii) Partial equilibrium analysis: A major limitation of the concept is that it is based upon the partial equilibrium analysis or particular product analysis. A more realistic explanation of it can be made in a general equilibrium setting.

(iii) Difficulties in international comparisons of effective rates of production: There are real problems in the exact measurement of heights of tariffs and comparison of tariff rates in one country with the other in the view of the presence or absence of certain groups of commodities or their varieties.

The tariffs also have certain indirect effects including the countervailing measures adopted by foreign countries. As these effects remain neglected, the effective rate of protection can not measure precisely the degree of protection. Some inputs are not traded. However their values are included in the total values of inputs and output. Consequently, the measurement of effective rate of protection is rendered faulty.

Despite its deficiencies, the concept of effective rate of protection has vital importance because it measures the extent to which the home market of a country is sheltered.

Lesson No. 2.3 Author: Manjinder kaur

POLITICAL ECONOMY OF NON-TARRIF BARRIERS

2.3.1 Introduction

Non-Tariff Barriers (NTBs) refer to restrictions that result from prohibitions, conditions or specific market requirements that make importation or exportation of products difficult or costly. These barriers arise from different measures taken by governments and authorities in the form of government laws, regulations, policies, conditions, restrictions or specific requirements and private sector business practices or prohibitions that protect the domestic industries from foreign competition.

2.3.2 Objectives of lesson

In this lesson we will discuss about the various types of non-tarrif barriers that affects a counties trade.

2.3.3 Explanation of the lesson

Non-tariff barriers are non-tax measures imposed by governments to favor domestic over foreign suppliers. Non-tariff barriers encompass a wide range of measures, for example, packaging and labeling requirements can impede trade, but usually only marginally. Other non-tariff measures such as quotas, voluntary export restraints, trade restraints under the multifiber arrangement, non-automatic import authorizations and variable import levies have much more significant effects. These nontariff measures are designed to reduce imports and thereby benefit domestic producers. The discussion below focuses on these non-tariff barriers.

2.3.3.1 Import Quotas

The import quota means the limitation of the quantities of different products to be imported from foreign countries within a specified period of time, usually one year. The import quota may be fixed either in terms of quantity or the value of the product.

Objectives:

a. To afford protection to domestic industries through restricting foreign competition by limiting the imports from abroad.
b. To make adjustment in the adverse balance of payments. The restriction of imports through quotas can reduce the balance of payment deficit faced by the country.
c. To conserve the scare foreign exchange resources of the country and to direct their use for high-priority import items.
d. To retaliate against the restrictive trade policies adopted by some of the foreign countries.
e. To improve the international bargaining position of the country through allocating larger import quotas for the products of such countries as allow a liberal inflow of the products of the home country.

Types of Import Quotas

The main types of import quotas are as below:

(i) Tariff or custom quota

In tariff or custom quota, a certain specified quantity of a commodity is allowed to be imported by the government of the importing either duty free or at a low rate of import duty. A tariff quota is either an autonomous quota or agreed quota. The autonomous tariff quota is fixed by decree or law. On the other hand, the agreed tariff quota is one which is the result of some agreement between the quota-imposing country and one or more foreign countries. This variant of import quota has some merits:

(a) This system has the advantage of flexibility and it synthesizes the tariff and import quota.

(b) As the imports above a specific limit are subject to a higher rate of tariff, this system on the other hand restricts imports and conserves scare foreign exchange resources and on the other hand, yields revenues to the government.

(c) This system does not completely prohibit imports. Some quantity of the importable goods is allowed to enter the home market either without duty or at very low rate of duty.

(d) The prices of the domestic products under this system remain related to the prices of the foreign products. The home prices of a given product are not supposed to exceed the foreign prices by more than the amount of custom duty leviable upon it.

(ii) Unilateral quota

Under this system, a country places an absolute limit upon the quantity of a commodity to be imported during a specified period. This limit is fixed without any prior negotiation or agreement with the foreign countries. The unilateral quota can be broadly of two types- (a) Global quota and (b) allocated quota. In case of global quota, the entire quantity to be imported may be obtained from any one or more countries during the specified period. Under the allocated quota system, the total quantity of import quota is allocated or distributed among the different exporting countries on the basis of certain criteria.

(iii) Bilateral quota

In case of the bilateral quota system, the import quota is fixed after negotiations between the importing and exporting country. The system has the following merits:

(a) There is no possibility of excessive fluctuation in imports and prices

(b) The exporting countries are not likely to resort to monopolistic practices.

(c) As the quotas are fixed after negotiations among the countries, there is discrimination against one or the other country.

(iii) Mixing quota

This is also known as indirect quota. Under this, the domestic producers in the quota-fixing country are required to make use of domestic raw materials along with the imported raw material in a specified proportion. This system of import quota has the following merits:

(a) It affords protection to the producers of raw materials.

(b) It saves the valuable and scarce foreign exchange resources of the country

(c) It induces the domestic processing of semi finished goods and manufacturing of finished goods.

(iv) Licensing of imports

Import licenses have proved to be effective mechanisms for restricting imports. Under an import licensing scheme, importers of a commodity are required to obtain a license for each shipment they bring into the country. Without explicitly utilizing a quota mechanism, a country can simply restrict imports on any basis it chooses through its allocation of import licenses. Prior to the implementation of NAFTA, for example, Mexico required that wheat and other agricultural commodity imports be permitted only under license. Elimination of import licenses for agricultural commodities was a critical objective of the Uruguay Round of GATT negotiations and thus the use of this mechanism to protect U.S. agricultural producers is unlikely an option for the 2002 Farm Bill. The government of a country may prescribe anyone of the systems of import quota mentioned above. The most crucial aspect

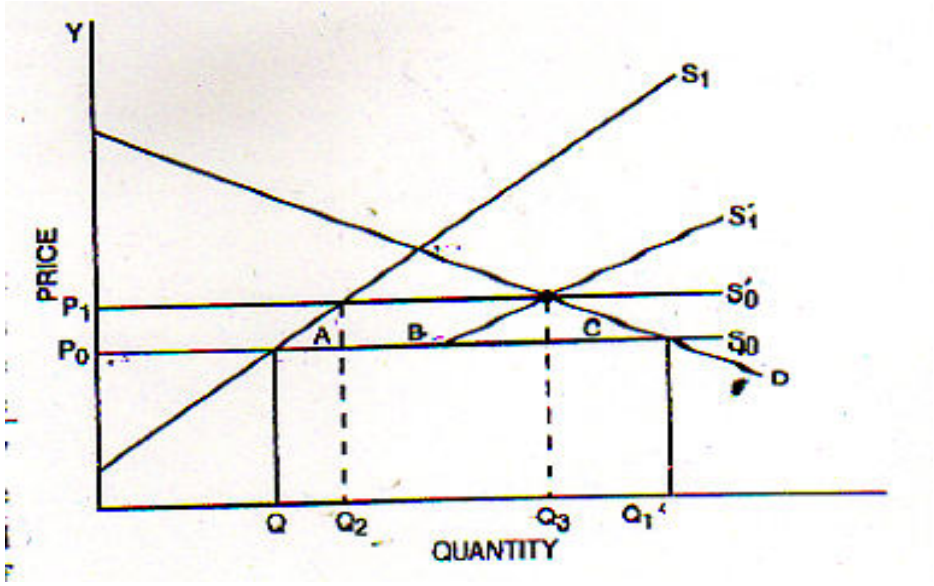
of any system of fixation of quota is its administration. For this purpose, the government may follow the mechanism of issuing licenses to different categories of imports on the basis of specific terms, conditions and norms. The system has the following main merits:

(a) It does not permit wide fluctuations in prices.
(b) This system has a great deal of flexibility and is easily adaptable to changing situations.
(c) It ensures the economical use of foreign exchange resources of the country.
(d) It tends to discourage the speculation in foreign exchange.
(e) The licensing authorities have effective control over the volume of imports.

2.3.3.2 Voluntary Export Restraints (VER)

These restraints refer to a situation in which the importing country faced with excessive competition from industries of the exporting country, threatens to put more stiff all round trade restrictions. That may induce the exporting country to reduce the flow of exports voluntarily to the importing country. The United States and other industrial countries have successfully negotiated with Japan since 1950's to make the latter curtail its exports of textiles to them. During 1980's again U.S.A. employed this method to make Japan and some other countries to reduce voluntarily their exports of automobiles, steel, shoes and certain agricultural commodities.

The voluntary export agreements sometimes cover more than one country. The most famous example of such an agreement is the Multi-Fiber Arrangement (MFA) that restricts textile exports from 22 countries. The effects of VER upon the importing country may be explained through Figure 1.1



In Figure 1.1, D is the domestic demand curve and S_1 is the domestic supply curve of good. Originally the world supply curve of the good at price OP_0 is S_0. The quantity imported is QQ_1. If the exporting and importing country enter the voluntary export agreement about the import of Q_2Q_3 quantity by the home country at the price OP_1, the world supply curve shifts to S_0. The domestic supply curve shifts to S_1. The net loss to the importing home country is measured by the area (A+B+C). In case of tariffs, the area B represents the revenue gain to the government of the importing country. In case of equivalent VER, the equivalent amount is taken away by the foreign exporters in the form of rents. It is in fact this consideration of rent that makes the foreign suppliers to enter into the voluntary export arrangement.

The foreign suppliers enter into such an agreement because they can later supply high cost or luxury item to the importing country and increase their rent earnings. In addition, such an agreement allows them to have an opportunity of protected market for their products. There is also the fear that not making of such as an arrangement will result in tariffs or other restrictions upon their exports. The voluntary export restraints, if successful, will have exactly similar effects as are associated with import quotas. The only difference is that these are administered by the exporting country.

These restraints are likely to be less effective for various reasons.

(a) The exporting countries are very reluctant in agreeing to these restraints. Generally, such agreements involve protracted negotiations.

(b) The agreement may be binding upon a specific country. As exports are reduced by the given exporting country, the other countries may enter the market and enlarge their exports. It means there is no reduction in imports hut only a replacement of imports from one country by those from the other.

(c) The country, forced to restrict the export of the commodity of a particular price and quality specification, may fill up its quota of market through products of upgraded quality specification and a higher level of price.

(d) The exporting country may continue to export through the third country trade.

(e) This measure successfully employed by an economically powerful country like the U.S.A. The less developed countries, faced with competition from the products of advanced countries, can not to scale down their exports.

(f) The VER result in the worsening of the terms of trade in the case of importing country because the domestic price of exporting country's product is higher this the international price.

(g) The VER discriminate against the low cost exporters. It is possible that imports are made from the higher cost exporters resulting in an increase in the bill of the importing country.

If the advanced countries resort to this measure against the exports of manufactured goods from the less developed countries, it can have ruinous effect upon their programme of industrialization in particular and economic growth in general.

2.3.3.3 Technical, Administrative and other Regulations

Another non-tariff barrier to international trade is in the form of numerous technical, administrative and other regulations. Among these regulation are included the safety regulations for automobiles and several other categories of machines, health regulations related to production and packaging of edible products, patent and copyright provisions and

labelling requirements showing origin and contents. Some of these regulations are, undoubtedly, legitimate, while some arc meant essentially for protecting domestic production against imports from abroad. For instance, French ban on advertisement of Scotch Whisky, British restriction on the showing of foreign films on British T.V. are veiled devices for restricting imports. Still another form of trade restriction is one which has emanated from laws. For example, 'Buy American' Act passed in the U.S.A. in 1933 provided for procurements by the government agencies. These procurement plans assure price advantage to the domestic suppliers. Many countries, including both the advanced and less developed countries, have their procurement programmes out of the domestic production. The Tokyo Round of GATT negotiations led to an agreement that countries would avoid such practices and allow the foreign suppliers also a fair chance. One more form of restrictions on trade is the tax rebates given to the exporters from such indirect taxes as sales tax, excise duty and value added taxes. This practice is extensively followed by both less developed and the advanced countries to place their respective exporters in a relatively better position. The trade is also restricted by such measures a international commodity agreements, multiple exchange rates, government procurements, customs valuation and classification, still import licensing procedures, local content regulations etc. All these measures are clearly intended to benefit the home country at the expense of the rest-of-the-world. No doubt, there is need for removing these trade barriers but much progress in this direction is not likely to take place in the near future. The advanced countries like the U.S.A. want to maintain the trade restrictions against the other countries. As regards other countries, they are being pressurised to liberalise trade. Such an altitude is a major hindrance in the dismantling of the regime of technical, administrative and other regulations,

2.3.3.4 Trade Restrictions due to International Cartels

An international cartel is an organisation of suppliers of commodity located in different countries that agrees to restrict output and export of the given commodity with the object of increasing or maximising profits.

According to Kindelberger, "Cartels are business agreements to regulate price, division of markets or other aspects of enterprises".

In the opinion of Haberler, the international cartel is an act of "uniting Producers in a given branch of industry, of as many countries as possible, into an organisation to exercise a single planned control over production and price and possibly to divide markets between different producing countries".

The most prominent example of international cartel is OPEC (Organisation of Petroleum Exporting Countries), which by restricting output and exports, could push up the price of crude oil by four times between 1973 and 1974. Another instance of international cartel is International Air Transport Association (TATA) which is a cartel of major international airlines. It meets annually to prescribe international air fares and policies.

The international cartels are likely to be successful, if they fulfill certain requirements. Firstly, there are only a few suppliers of the given commodity. Secondly, the suppliers are amenable to discipline and uniform business conduct. Thirdly, the product is produced on a large scale and no by the small or medium sized firms. Fourthly, the commodity is such for which no close substitutes are available.

There is greater scope for the formation of international cartels in such group of industries as have the following characteristics:

(a) The industries are those which hold control over certain important minerals or other raw materials and the supply of which can be easily brought under effective and strict control as petroleum, iron, aluminium, sulpher etc.

(b) International cartels can be organised among such industries whose products are patented as in the case of electrical and electronic industries, chemicals, drugs and pharmaceutical industries.

(c) Cartels can exist among those groups of industries which enjoy economies of large scale production in an abundant measure.

The organisation of international cartels is supported on the following main grounds:

(i) The strong international cartels can make the importing countries to either remove or lower the tariffs. If that happens, the welfare of the international community is likely to be maximised.

(ii) The cartels eliminate cut throat competition and price war. That can lead to supply of products at stable prices. Thus international cartels can ensure stability in international prices.

(iii) If international cartels exist, there is much economy in respect of wasteful spending on advertising.

(iv) International cartels ensure pooling of technological know how. The specialised and highly standardised products can be manufactured at very low costs and made available to all the prospective importing countries.

(v) The international cartels promote international agreements and economic co-operation.

There is strong opinion against the formation of international cartels. The main arguments against them are as below:

(a) The organisation of cartels throttles competition and results in the exploitation of consumers through high prices and sub-standard products.

(b) The argument that international cartels pave the way for reduction in tariffs is not valid. This benefit has not actually materialised. In the words of Haberler,"… international cartels are not a suitable instrument for demolishing tariff walls within any measurable time. Many of the present international cartels owe their own existence to tariffs. They are, therefore, scarcely adopted for destroying tariffs".

(c) The participating firms, belonging to different countries, have to follow a uniform policy which may not be consistent with the economic interests of at least some of the countries.

(d) An international cartel is formed through a loose agreement. If a member country is not satisfied with production quota, division of market or other policies, it may decide to leave the cartel. That threatens the existence of cartel.

(e) The successful cartels, except in the case of OPEC, are not likely to be organised in the LDC's dominated by agriculture and handicrafts, where production is distributed too extensively among small producers. Most of the international cartels are formed by the advanced industrialised countries and these have served as the instruments of exploitation of the LDC's and restriction of the international trade.

(f) Any one supplier of a given product may decide to remain outside the cartel and make unrestricted sales at the prices slightly below the price fixed by the cartel. Such a situation was faced by OPEC too, when the countries like Britain, Norway and Mexico decided to remain outside that organisation.

(g) Cartels are inherently unstable as these are threatened by competition from non-members and internal wrangling among the members.

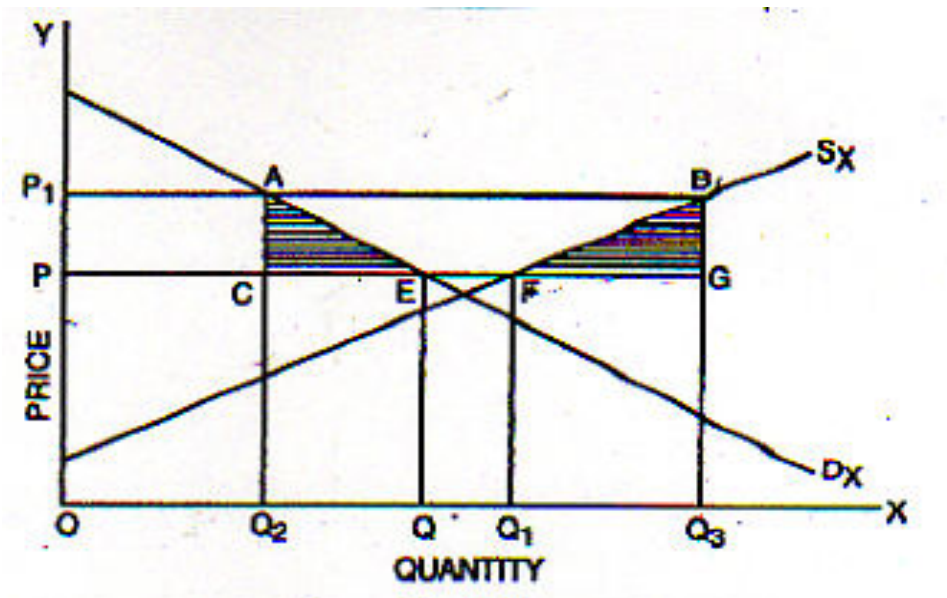
In view of their serious shortcomings and restrictive effects upon trade and growth, the international opinion, at least in theory, is against the formation of international cartels.

2.3.3.5 Export Subsidies

An important non-tariff device to influence the international trade and especially to expand home country's exports is the export subsidies. The export subsidies are direct cash payments or the granting of tax relief and subsidised loans to nation's exporters or potential exporters or low interest loans to the foreign buyers stimulating exports. Although the international agreements do not approve of resort to export subsidies, yet both developed and poor countries have extensively employed this device either in an explicit or disguised form. During the recent years, the issue of farm subsidies became a matter of confrontation between the United States, on the one hand, and the countries of European Community (EC) and Japan on the other, it has resulted in the collapse of W.T.O. negotiations held at Cancun in September, 2003.

In 1984-86, the average rates of subsidies on farm products in Japan, the EC and the U.S.A. were 64 percent, 49 percent and 35 percent respectively. In Japan, the highest rate of subsidy among the farm products was 96 percent in the case of wheat and the lowest rate was 16 percent in the case of poultry. In the EC, the highest and lowest rates of subsidy

were 75 percent and 18 percent in case of sugar and eggs respectively. In the United States, the highest and lowest rates of subsidies in that year were 76 percent and 7 percent in case of sugar and eggs respectively. The United States insisted that the EC and Japan should scale down subsidies on so that the United States products could have greater access to the foreign markets. The effect of export subsidy the cost of protection due to subsidies can be examined through Figure 1.2



In figure 1.2, D_x and S_x are the demand and supply curve of the exportable commodity X of the home country A. The free world price of the commodity is OP. At this price, the domestic supply is QQ_1, and demand is OQ so that exportable surplus is QQ_1. If PP_1 per unit subsidy is extended, the price for domestic consumers and produce is OP_1. At this Price, the quantities demanded and supplied are respectively OQ_2 and OQ_3. The exportable surplus expands from QQ_1 to Q_2Q_3. The increase in domestic price results in a loss in consumer's surplus by $PEAP_1$. The gain in producer's surplus, on the other hand, is PFB P_1. The cost of subsidy is

$PP_1 \square Q_2Q_3 = AC \square AB = ACGB$

Net Loss or the Cost of Protection	= Loss in Consumer's Surplus	+	Cost of Subsidy	-	Gain in Producer's Surplus

$= PEAP_1 + ACGB - PFBP_1$

$= \Delta ACE + \Delta BFG$

Thus the redistributive effects related to export subsidies can cause a net loss in welfare exporting country apart from the fact that the products of other countries will be at disadvantage in foreign markets. As other countries also resort to counterveiling duties or subsidies, there can be a serious restrictive effect upon the international trade.

2.3.3.6 Countervailing duties (CVDs)

Countervailing duties (CVDs) are trade import duties imposed under World Trade Organisation (WTO) rules to neutralize the negative effects of subsides. They are imposed after an investigation finds that a foreign country subsidizes its exports, injuring domestic producers in the importing country. According to (WTO) rules, a country can launch its own investigation and decide to charge extra duties, provided such additional duties are in accordance with the GATT Article VI and the GATT Agreement on Subsidies and Countervailing Measures. Countries can rule domestically whether domestic industries are in danger and whether foreign countries subsidize the products, the institutional process surrounding the investigation and determinations has significant impacts beyond the countervailing duties.

In the Uinited States countervailing duties are assessed by the International Trade Administration of the U.S. Department of Commerce which determines whether imports are being subsidized and, if so, by how much. If there is a determination that there is material injury to the competing domestic industry, the Department of Commerce will

instruct U.S .Customs and Border Protection to levy duties in the amount equivalent to subsidy margins. Petitions for remedies may be filed by domestic manufacturers or unions within the domestic industry, but the law requires that the petitioners represent at least 25 percent of the domestic production of the goods for which competition is causing material injury.

2.3.3.7 Dumping

The widespread impression about the term 'dumping' is the selling of product in the foreign market below cost. But that is a wrong conception of dumping. Ellsworth and Leith defined dumping as "sales in a foreign market at a price below that received in the home market, after allowing for transportation charges, duties and all other costs of transfer". In the words of Haberler, "dumping is the sale of a good abroad at a price which is tower than the selling price of the same good at the same time and in the same circumstances (that is, under the same conditions of payments and so on) at home, taking account of differences in transport costs". Thus the essential feature of dumping is price discrimination between the two markets. It is not necessary that the price discrimination or dumping occurs between the home market and foreign market. It may also take place between two regions in the home market or between two foreign markets.

Dumping has been classified into three main parts:

(i) Persistent

(ii) Predatory and

(iii) Sporadic.

The persistent dumping occurs when the domestic monopolist has a continuous policy, to sell his product at a higher price in the domestic market than in the foreign market with the object of securing maximum profits. This kind of dumping can exist when the domestic demand for the product is inelastic hut the foreign demand for the product is highly elastic. The predatory dumping is one in which a commodity is sold at below cost or at a lower price in the foreign market temrari1y with the object of driving the rivals out of that market. After the object is achieved, the prices arc raised to take the benefit of newly acquired

monopoly position in the foreign market. The sporadic dumping is the occasional sale of a commodity either at below cost or at lower price in the foreign market temporarily with the object of driving the rivals out of that market. After the object is achieved, the prices are raised to take the benefit of newly acquired monopoly position in the foreign market. The sporadic dumping is the occasional sale of a commodity either at below cost or at a lower price in the foreign market than in the home market for the purpose of getting rid of unforeseen and temporary glut of inventory stocks that can not be disposed of in the home market. This kind of dumping can take place if the demand for the product in the foreign market is more elastic than its demand in the home market.

The dumping can be successful or effective, if the following conditions exist:

(i)The producer should be a monopolist in the home market. If there are perfectly competitive conditions in the home market, the price will be equal to the average cost of marginal cost. In such a situation, the home producer cannot charge a lower price in the foreign market unless the government pays out subsidy to the home producers for making larger exports.

(ii) There should not be any possibility of the cheaper goods supplied in the foreign market flowing back to the home country. In order to prevent the flow back of the commodity, it is important that the difference between the foreign low price and domestic high price is less than the transport cost involved in the re-export of the commodity back to the country of origin.'

Dumping is supposed to be beneficial from the point of view of the exporting country. It believed that dumping makes the country get rid of unintended glut which, if disposed of in the home market, could have caused fall in prices and consequent slump in the system. If producer incurs any loss due to price difference, it can he easily compensated by the charging of high prices in the home market. In the case of persistent dumping, the domestic price may be higher than before dumping only when the production is governed by the increasing cost. Such a possibility is unlikely to exist, if the production is governed by the law of constant costs of the law of decreasing costs. In the latter case (decreasing costs), it

is possible that the producer charges a lower price in the long run even from the domestic buyers. In such a situation, there will be an increase in the level of welfare in the home country.

The persistent dumping is not likely to have adverse effect even upon the importing country because the goods are available at low prices continuously. But the effects of dumping production in the importing country have to be assessed carefully, if dumping occurs in respect of consumer goods or producer goods, it may cause injury to industrial expansion. In case the exporting country has been dumping cheap raw material, the importing country may he able to establish some processing industries. The persistent dumping is not likely to cause much harm to the economy of the importing country. It is often the sporadic dumping that causes injury to the latter. That is precisely the reason that the importing countries feel the necessity of adopting countervailing measures. These measures include anti-dumping duties which are equivalent to the difference between the selling prices in the exporting and the importing countries. In addition, the importing country may protect its industries from foreign dumping through the enforcement of import quotas.

Since the middle of 1970's, the non-tariff barriers to trade have grown much more rapidly than the tariff barriers. At a time when WTO and other international economic institutions have been striving to reduce the tariff barriers, it is naturally a matter of great concern that almost half of the world trade is presently subject to non-tariff trade barriers. In the Uruguay Round of trade negotiations, the leading countries have arrived at an agreement for dealing with the non-tariff trade barriers. However, any such trade arrangement, to succeed, must be fully consistent with the economic interests not only of the advanced countries but also of the less developed countries. Now a days, industrialized countries have moved from tariffs to NTBs. Firstly, in the formation of nation-states, governments had to get funding. They received it through the introduction of tariffs and most developing countries still rely on tariffs as a way to finance their spending. Developed countries can afford not to depend on tariffs, at the same time developing NTBs as a possible way of

international trade regulation. The second reason for the transition to NTBs is that these tariffs can be used to support weak industries or compensation of industries, which have been affected negatively by the reduction of tariffs. The third reason for the popularity of NTBs is the ability of interest groups to influence the process in the absence of opportunities to obtain government support for the tariffs.

Self check exercise

Q1. What is dumping?

Q2. Is cartels affects the international trade?

Q3. What is the Voluntary Export Restraints (VER)?

Q4. Explain the non-tariff trade barriers?

2.3.4 Summary

In this lesson we have discussed that how different forms of non-tariff barriers affects the international trade. The import quota is the limitation of the quantities of different products to be imported from foreign countries within a specified period of time, usually one year and it is a good measure of non-tariff barriers. An import license is also an effective mechanism for restricting imports because under an import licensing scheme, importers of a commodity are required to obtain a license for each shipment they bring into the country. VER refer to a situation in which the importing country faced with excessive competition from industries of the exporting country, threatens to put more stiff all round trade restrictions

2.3.5 Short answer type questions

a. Explain voluntary Export Restraints?

b. What is the meaning of import quotas?

c. What are the main types of import quotas?

d. Explain briefly the non-tariff barriers to trade?

e. Explain the effects of export subsidies?

f. How and in what way cartels restrict trade?

g. Explain the effects of dumping upon the trading country?

2.3.6 Long answer type questions

a. Briefly examine the effects of Voluntary Export Restraints (VER)?

b. Explain the main non-tariff barriers to trade?

c. What is a cartel? Is cartel affects the international trade?

d. Analyse the effects of export subsidies upon trade?

e. What is the meaning of import quotas? What are their main types?

f. What is dumping? Explain its various forms? How does it affect the trading country?

2.3.7 Suggested readings

1. C. P. kindleberger: International Economics
2. Bo, Soderston & Geoffrey Reed: International Economics
3. D. K. Salvatore: International Economics
4. K. C. Rana & Verma, K. N: International Economics

M.A (ECONOMICS) PART-II **PAPER-304-305 (Option-I)**

(SEMESTER-III) **INTERNATIONAL ECONOMICS**

LESSON NO.2.4 **AUTHOR: MANPREET KAUR BHUTTA**

INTERNATIONAL ECONOMIC INTEGRATION: BILATERAL AND MULTILATERAL TRADE AGREEMENTS

2.4.1 Meaning of Economic Integration

The modern industrial system rests upon such techniques that can be employed economically only if the production takes place on a very large scale. This requires expanding markets on the one hand and increasing purchasing power with the people on the other. For the fullest exploitation of the production potential of the modern techniques, certain countries having small internal geographical markets, have attempted to organize themselves into regional groupings. The economic integration, in the broadcast sense, means the unification of distinct economies into a single larger economy.

The tariff and other restrictions upon trade are applied in a discriminatory manner. Such discrimination is of two forms--- country-discrimination and commodity-discrimination. The economic integration, according to Salvatore, is the "commercial policy of discriminatively reducing or eliminating trade barriers only among the nations joining together." Thus the economic integration refers to an arrangement whereby two or more countries combine into a larger economic region through the removal of discontinuities and discriminations existing along national frontiers, while following a common tariff and trade policies against the countries outside the group. Tinbergen has defined economic integration as "the creation of the most desirable structure of international economy, removing artificial hindrances to the optimum operation and introducing deliberately all desirable elements of co-ordination and unification. Tinbergen has distinguished between the negative and positive aspects of integration. The negative aspects of integration involve the removal of discrimination and restriction on the movement of goods among the member countries the positive aspects of integration involve the adoption of such policy measures and institutional arrangement as facilitate the removal of market distortions within the given economic region. The economic integration can be understood both as a process and as a state of affairs. As a process, it is concerned with the measures which aim at abolition of discrimination between economic units belonging to different nation states among which there is an absence of various forms of discrimination.

2.4.2: Objectives of Lesson

In this lesson we have discuss economic integration, types and benefits of economic integration and commodity agreements. Explain the bilateral and multilateral trade agreements.

2.4.3 Benefits of economic integration: the economic integration between two or more countries brings the following main benefits:

I. Economies of scale: the individual countries, having small internal market, have limited capacity to expand production. The economic integration provides an unrestricted access of the products produced by any member country. This gives strong inducement to expand production and exploit fully the economies of scale.
II. International specialization: the economic integration enables the member countries to attain a greater degree of specialization in both products and processes. Specialization based on comparative cost advantage by a specific geographical region can cause considerably large expansion in production.

III. Qualitative improvement in output: the regional economic co-operation among a number of countries leads to rapid technological changes and larger and easier capital movements. The member countries, in such favorable conditions, can bring about qualitative improvement in production.

IV. Expansion of employment: as some countries organize themselves into regional economic groups and allow unrestricted flow of labour within the region, there can be maximization of employment and income.

V. Improvement in terms of trade: the economic integration greatly increases the bargaining power of the member countries vis-à-vis the rest of the world. That brings about a significant improvement in their terms of trade.

VI. Increase in economic efficiency: the economic integration results in increased competition within the region. That helps in maintaining a higher level of economic efficiency of the group as a whole.

VII. Improvement in living standard: as some countries organize themselves into regional groups, there is easier availability of superior varieties of goods at competitive prices. The increase in employment opportunities and the purchasing power too contributes in improving the living standards of the people.

2.4.4 Forms/types of economic integration

The essence of economic integration is the economic co-operation among the participating countries. On the basis of the degree of co-operation, the economic integration can be of the following main forms:

I. **Preferential trade area or association:** the preferential trade area or association is the most loose from each other. It means they offer preferential treatment to the member countries. As regards the outside world, they continue to maintain their individual tariffs. The best instance of preferential trade area or association is the Commonwealth System --of Preferences, established in 1932. It is headed by Britain and includes all the Commonwealth countries.

II. Free trade area: in this form of economic integration, the member countries abolish completely both tariff and quantitative trade restrictions among themselves. However, each member country is free to maintain its own trade barriers against the non-member countries. An important example of Free Trade Area is the European Free Trade Association (EFTA). This association was found in November, 1959. It included such countries as United Kingdom, Austria, Denmark, Norway, Sweden, Portugal, Switzerland and Finland as Associate Members. Another Such

Association Is Latin American Free Trade Association (LAFTA). It is formed in June 1961 by 10 Latin American countries.

III. Customs union: a more formal type of integration among two or more countries is the customs union. In the form of integration; the member countries abolish all tariffs and other barriers on trade among themselves. As regards the rest of the world, they adopt a common external tariff and commercial policy. The customs unions and free trade area are similar in respect of abolition of all trade barriers for the member countries. But the customs union is distinct from the free trade area in respect of the common external tariff against non-member countries.

IV. Common market: the common market signifies a more unified arrangement among a group of countries than the customs union. The common market involves the abolition of tariff and trade restrictions among the member countries and adoption of a common external tariff. It goes even beyond that and allows free movement of labour and capital among the member nations. Thus in case of a common market, there is a free and integrated movement of goods and factors among the member countries. The European Common Market (ECM) called also as the European Economic Community (EEC) is the best example of the common market.

V. Economic union: the most advanced from of economic integration involving the greatest degree of co-operation is the economic union. In case of an economic union, two or more countries form a common market. In addition, they proceed to harmonize and unify their fiscal, monetary, exchange rate, industrial and other socio-economic policies. An example of economic union is BENELUX (including Belgium, Netherlands and Luxembourg) which was formed in 1948 initially as a customs union but later got converted into an economic union in 1960. These countries have now joined the EU. The European Economic Community (EEC) has transformed itself into an economic union called as European Union (EU) in 1991.

2.4.5 Commodity Agreements

International commodity Agreements are inter-governmental arrangements concerned with the production and trade of certain primary products.Many developing countries which embark upon ambitious development programmes need large foreign exchange resources to finance some of their developmental requirements like import of capital goods. But they face problems like fluctuations in export prices of primary goods, i.e. agriculture products and minerals, which form a major part of their total exports. Apart from making export earning unstable, it also causes deterioration in terms of their trade. Hence, there has been a growing demand for adopting stabilisation measures to protect the interests of developing

countries. International commodity agreements, it is believed, can help stabilise prices of the respective commodities.

Commodity agreements have been tried in different cases for quite some time now. "the worsening condition of primary product exporters in terms of trade in the second half of the fifties, their lagging export earnings, inadequate reserves, mounting external indebtedness, and the consequential frustration of plans for rapid economic development caused these countries to look around for ways of escaping from their predicament. Out of this search came the idea that commodity agreements could be used as a way of raising (or halting a fall in) the world prices of commodities and in this way of transferring income from consuming to producing countries.

2.4.6 Objectives of Commodity Agreements

The Promotional of Health and Morals: the outstanding example of international agreements for the purpose of promoting health and morals is the international regulation of the trade in opium and narcotics.

The Conservation of Resources: the conservation of natural resources is a direct or indirect objective of nearly all international raw materials scheme. This is one of the objective of the OPEC.

Security Objectives: inter-government agreements may also be useful as a offsetting preventive war measure by a scramble for scarce strategic materials for national stockpiling or other security purposes.

Price Stabilisation: as has already been described above, price stabilisation is a very important purpose for which commodity agreements have been entered into.

The Management of Surplus: commodity agreements are sometimes entered into to manage the surplus. During times of bumper crops, there may arise a problem of surplus. Such surplus should be properly managed to avoid serious adverse effects on prices and also with a view to hold stock for the lean periods

. 2.4.7 The Bilateral and Multilateral Agreement

Restrictions to trade may be whittled down by: (i) having pairs of countries reduce tariffs and other barriers to and other barriers to each other's trade , (ii) having three or more countries take steps to accomplish the same purpose ; or (iii) a single nation acting entirely on its own initiative and independently of action taken by other countries. These methods

are known respectively as the bilateral, multilateral, and unilateral approaches to freer trade. Since the unilateral case is extremely simple in principle and extremely rare in practice, we propose to confine our discussion here to the bilateral and multilateral methods.

2.4.7.1 Bilateral Agreement:

Bilateral approach to purchase and sell certain quantities of a commodity at the agreed upon prices may be entered into by the major importers and exporters of the commodity. In such an agreement upper prices and lower prices are specified. If the market prices throughout the period of the agreement remain within these specified limits, the agreement becomes inoperative. But, if the market prices rise above the upper limit specified, the exporting country is obliged to sell the importing country a certain specified quantity of the commodity at the upper price fixed by the agreement. On the other hand, if the market price falls below the lower limit specified, the importer is obliged to purchase the contracted quantity at the specified lower price.

In the case of the bilateral approach to freer international trade the procedure consists of swapping commitments to lower the barriers which each country places on imports from the other. Now, if the result is simply the reciprocal reduction of barriers, so that the benefits are confined to the two contracting states, the outcome is really not different from that described previously in the case of commercial reciprocity. Freer trade would result, to be sure, but only at the expense of a measure of international discrimination. Third states, although faced with trade barriers which are not higher than before in the two contracting states, would now find that they are at a relative disadvantage. They are faced with barriers which are higher than those with which the two contracting states have to contend.

When barriers are reduced bilaterally, the way to avoid discrimination is to invoke the MFN (Most Favoured Nation) clause in its unconditional form. This means that if countries A and B lower tariff rates on certain commodities of interest to each other, the lower rates immediately apply to the imports of such commodities from all other countries, provided that the other countries are not found to be discriminating against the trade of A and B. In this manner the reduction of trade barriers is bilateralistic only in regard to the way in which the problem is approached. In substance there is an across the board or multilateral application of result achieved in bilateral discussion and agreements thanks to the role of the unconditional MFN clause. Although not without its limitations the bilateral approach to freer trade has been partially successful.

2.4.7.2 Multilateral Agreements:

Multilateral agreements when international sale and purchase contracts may also be entered into by two or more exporters and importers. The bilateral or multilateral agreements are usually concluded between the major supplier(s) and the major importer(s) of the commodities. The best known example of this type of commodity agreement is the International Wheat Agreement which fixed the maximum price at which the exporting countries guaranteed to supply stipulated amount of wheat to the importing countries and minimum price at which the importing countries agreed to purchase fixed amounts of wheat from the exporters.

Multilateral agreements are arrived at when three or more nations arrange to whittle down barriers to international trade. Tariffs to be sure are no longer the only or in some cases even the most important trade barrier so that we must bear in mind that successful multilateral tariff reform desirable as it may be is not synonymous with a successful attack on the complicated trade barriers problem. For example, such restrictive devices as exchange control and import quotas would still exist or would still present a problem. The non-tariff restrictions, however do not lend themselves to reasonably precise comparative treatment because they are so internationally diverse in character, complicated in structure and unpredictable in incidence. Some form of direct action tailored specifically to fit individual cases, will be required to cope with the problem of non-tariff controls over international trade.

Before specific alternative methods of reforming tariff system are considered a few words need to be said about some of the general consequences of the systematic reduction of tariff duties. In the first place since even very high cost domestic industries usually include firms efficient enough, at some workable scale of output, to be able to face foreign competition without the aid of protection, the reduction (or abolition) of particular tariff duties need not involve making the domestic economy completely dependent on foreign sources of supply for the commodities involve short-run deflationary effects. The timing of such a reduction of tariffs is, therefore, of utmost importance. Ideally, such reform should be timed to coincide with the periods of widespread adjustment of production, as, for example, is the case immediately before the period of conversion of industry to peace production at the end of major wars.

If the best results are to be obtained the systematic reduction of tariff requires that changes should be based on a multilateral approach. Agreements between pairs of countries will still prove useful in dealing with special problems not important enough to be included in a

broad agreement involving many countries that is to say such bilateral agreements should supplement multilateral agreements. Bilateral arrangements should always be in harmony with the provisions and spirit of multilateral facts. In the political domain, often such agreements have been used to reduce the weaker of the two countries to a state approaching vassalage.

A multilateral trade convention, to which all states would be invited, might appropriately serve as the vehicle through which a broad international reduction of tariffs could be effected. The convention would also consider other matters, such as customs formalities, quotas, import and export prohibitions and cartels. These other matters give rise to problems no less important than the tariff problem. But tariff reform should logically get the first priority, since tariffs are basically simpler devices than many of the other restrictive measures.

We come, then, to a consideration of several methods of reducing tariff barriers multilaterally- that is, by a number of countries simultaneously, each nation extending reductions agreed upon with particular states to imports from all other nations not found to be discriminating against that country's exports. For instance, the methods employed can be:

a. The reduction of all protective duties existing at a particular time to a given percentage ad valorem, provided that in no case will the duties be reduced below a specified percentage ad valorem,
b. Another method would be to require the uniform reduction of all protective-tariff duties in all countries by a given percentage of their height on a certain date. The several advantage of the second method are that (i) it will preserve to a large degree the tariff structure or the relationships between the tariff rates on different commodities; (ii) it will be simple to administer in all countries; and (iii) it will have the appearance of treating all countries alike. On the other hand, the method would be regarded as inequitable by low tariff countries. The seriousness of this criticism may be appreciated if it is noted that this method would reduce low tariffs to the same relative extent as high tariffs.

International agencies have been formed with the objective in part of restoring trade to a multilateral basis, and increasing the total amount of trade. Member-nations are to be discouraged from distorting free market forces to their advantage. Multilateralism is based on the principle that each country purchase in the cheapest markets and credits and debits are pooled to square up disequilibrium in balance of payment. What is more, under

multilateralism, all countries are treated without discrimination. Hence, as much as with the amount of trade, the concern is with the misdirection of trade and uneconomic allocation of factors of production. Quotas, exchange control, multiple exchange rates, bulk buying, customs unions, and export subsidies- these all tend to distort the pattern of trade. Apparently to restore trade to the channels dictated by comparative costs requires intervention by international agencies once the misdirection has assumed serious proportions; dependence on free market forces to restore trade more nearly in accord with comparative costs will not be adequate.

2.4.8 Conclusion

The WTO points out that the past decades have not been kind to international commodity agreements either. Some have collapsed; others faced adverse market conditions which made attempts at stabilization impractical. Others were not able to raise the funds to intervene effectively, while still others have suffered from disagreement over the division of the benefits among countries. Different have also arisen in circumstances where the implicit objective of price stabilization schemes has been to change secular trends in prices rather than smooth out fluctuations in prices.

2.4.9 Short answer type questions:

1. What is economic integration?
2. What do you mean by bilateral agreement?
3. Briefly explain the multilateral agreement?
4. Explain the forms/types of integration?

2.4.10 Long answer type questions

1. What is economic integration? Discuss the bilateral and multilateral agreements ?

2.4.11 Suggested readings:

International Economics: Francis Cherunilam

International Economics: H.G.P. Srivastava

International Economics: Krugman, P.R and Obstfeld, M

International Economics: Soderston, B.O.

International Economics: Charles and P. Kindleberger

Lesson No. 2.5

Custom Union

2.5.1 Introduction

Before J. Viner developed the theory of customs union, there was a general belief that customs union raises the level of welfare as customs union is a movement towards freer trade at least within a specific area. Viner pointed out that the conclusion concerning increase in welfare due to customs union is not necessarily true. He analysed the *production effects* of customs union through the concepts of *trade creation* and *trade diversion.* The works of the writers like Meade, Lipsey, Lancaster and many others analysed the *consumption effects.* H.G. Johnsonfollowed a partial equilibrium approach to investigate fully the effects of a customs union by incorporating both the production and consumption effects.

2.5.2 Objectives of the lesson

In this lesson we will study about custom union, partial and general approach of custom union approach and effects of custom union.

2.5.3 Partial Equilibrium Analysis of Customs Union

A custom union is an organisation that includes two or more countries. They abolish tariff and other trade restrictions among themselves and adopt a common external tariff against the non-member countries. The *static effects* of a customs union in a partial equilibrium system, on the lines suggested by Viner, Meade, Lipsey and Johnson, can be studied on the basis of the *assumptions* given below:

(i) The customs union includes two countries—the home country A and the partner country B.

(ii) The rest of the world is denoted by'a third country, say country C.

(iii) The customs union imposes a common external tariff.

(iv) There is an absence of any other type of trade restriction.

(v) The customs union imposes only a specific tariff.

(vi) The three countries produce only one commodity say, X.

(vii) The home country A was the highest cost country and the country C was the least cost country before the formation of the customs union.

(viii) The supply curves are perfectly elastic in countries A and C.

(ix) The production is governed by constant return to scale.

(x) There is perfect competition in both product and factor markets.

(xi) The supply of productive inputs is fixed.

(xii) There is a state of full employment of resources.

(xiii) The techniques of production are given and constant.

(xiv) The transport costs are absent.

(xv) The home country is originally having a balance of trade equilibrium, *i.e.,* exports equal imports.

The effects of customs union on production, consumption and trade, given the above assumptions can be explained in terms of trade creation and trade diversion due to customs union.

***2.5.3.1* Trade creation** : The formation of customs union involves the abolition of tariff among the member countries and imposition of common tariff against the rest of the world. It is supposed that the home country A is the least efficient country and its unit cost of producing a watch is Rs. 400. In the partner country B, which is more efficient, the unit cost of production of that watch is Rs. 320. The rest-of-the world is represented by non-member country C, which is the most efficient and the average cost of producing the same watch is Rs. 240 in that country. If, before the formation of custom union, the home country A imposes 100 percent tariff on all imports, the unit costs in B and C become Rs. 640 and Rs. 480 respectively.

TABLE 1. Trade Creation

Country	Unit Cost (in Rs.)	Unit Cost (in Rs.) with imposition of 100% of uniform import duty	Unit Cost (in Rs.) after formation customs union
A	400	400	400
B	320	640	320

In these circumstances, it is desirable for the home country A to produce the commodity domestically. If the customs union is formed and duty is removed on imports from B but it remains in the case of country C, the partner country B becomes the least cost country. Now the home country will prefer to import watches from B rather than produce it domestically. So the formation of customs union has resulted in the creation of trade.

2.5.3.2 Trade Diversion **;** It is possible that before the formation of the customs union, a given commodity (watches) was being imported from the most efficient and the least cost country C. After the formation of the customs union, as duty is removed from import from the partner country B, while it remains enforced on imports from C, the former becomes the least cost country. In such a situation, the home country A will start importing watches from the partner country B rather than non-member country C. Thus there is diversion of trade from outside country C to the partner country B after the formation of the customs union. It may be explained through the Table 2.

TABLE 2. Trade Diversion

Country	Unit Cost (in Rs.)	Unit Cost (in Rs.) with 50 percent	Unit Cost (in Rs.) after the formation
A	400	400	400
B	320	480	320

Table 2. shows that the unit costs of watch in the home country (A), partner country (B) and non-member country (C) before the formation of the customs union were Rs. 400, Rs. 320 and Rs. 240 respectively. Thus country C was the least cost or the most efficient country and the home country A was the highest cost country. As the home country imposes 50 percent duty on all imports, the unit costs in A, B and C become Rs. 400, Rs. 480 and Rs. 360 respectively. Since C is the least cost country, watches will be imported by A from this country. After the formation of the customs union, the import duty is abolished on imports from B, while it remains in case of non-member country C. The unit costs, in this situation, are Rs. 400, Rs. 320 and Rs. 360 in case of A, B and C respectively. As a consequence, country A will prefer to import watches from country B (partner country) rather than the outside country C. Thus the formation of customs union results in the diversion of trade from an outside country to the partner country. This is called as the trade diversion.

The partial equilibrium effects of the formation of the customs union can be analysed with the help of Fig. 1.

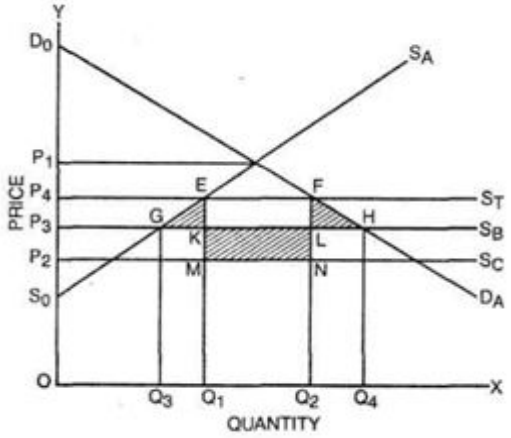


Figure: 1

In Fig. 1., quantity of the commodity (watches) is measured along the horizontal.1 scale and price along the vertical scale. D_A and S_A are the demand and supply curves respectively of the home country A. S_B and Sc are the perfectly elastic supply curves of countries B and C respectively. The selling price of country A is OP1 whereas the selling prices of countries B and C are respectively OP3 and OP2. Thus country C is the most efficient and the home country A is the least efficient.

Before the formation of the customs union, country A imposes P2P4 per unit tariff on allimports. Now the tariff-ridden price for country C is OP2 + P2P4 - OP4. It is still lower than A's selling price OP1, Country B is out of picture because its selling price inclusive of tariff is even higher than A's selling price. Country A will enter into trade with country C. At the tariff-ridden price P4, the domestic production by country A is OQ1 and the demand is OQ2 so that the quantity imported from country C is Q1Q2. The consumer's surplus in this trade equilibrium is D_0FP4 and producer's surplus is S_0EP4. The revenue receipts of the government in country A are EFLK. The measure of welfare before the formation of the customs union is D_0FP4 + S_0EP4 + EFLK = D_0FLKES_0.

If customs union is formed and the tariffs are removed in case of partner country B, while these continue to exist in case of the non-member country C. As the selling price OP3 of country B, is lower than that of country C, the home country will import watches from the partner country B and country C gets eliminated from trade. The main effects after the formation of customs union are as follows:

Price effect: As compared to the tariff-ridden price OP4, there is a fall in the selling price to OP3 after the customs union is formed.

Production effect : Before the formation of the custom union, the domestic production in country A was OQ1. After the customs union is formed, the domestic production falls from OQ1to OQ3. This fall in output is met through imports. The overall import is Q3Q4 which is more than the earlier imports Q1Q2. The increase in imports Q1Q3 that offsets the fall in domestic production is termed as Trade Creation Effect I.

Consumption effect: Before the formation of customs union, the quantity demanded was OQ2 and afterwards it is OQ4. Thus the demand for watches rises by Q2Q4. This additional demand is met through imports from the partner country B. Thus the increase in consumption Q2Q4 is the consumption effect. It is referred as Trade Creation Effect II. Jacob Viner had overlooked it but the writers like Meade, Gehrels, Lipsey and Johnson have recognised it.

Revenue effect : Before the formation of the customs union, the government in country A was obtaining revenues from tariff to the tune of EFLK. After the formation of customs union, since imports are being made from the partner country B, the government does not receive any revenues. Thus there is loss in government revenues to the extent of EFLK.

Given the trade creation effects I and II the total trade creation effect is (Q1Q3 + Q2Q4X

Welfare effect: The welfare effect due to trade creation can be assessed as below :

Gain in Consumer's Surplus = P4FHP3

Loss in Producer's Surplus = P4EGP3

Loss in Government Revenues = EFLK

Welfare Effect = P4FHP3 - P4EGP3 - EFLK

= AEKG + AFLH

Trade Diversion and Reduction in Welfare : While the trade creation results in a gain in welfare, the diversion of trade from a non-member country (C) to the member country (B) after the formation of customs union, involves some loss in welfare. The reason for it is that the trade gets diverted from a more efficient or low cost country C to the less efficient or high cost country B.

Before the formation of customs union, the home country A was importing Q1Q2 quantity of the commodity from the non-member country C. After the formation of customs union, the quantity imported is Q3Q4 out of which Q3Q1 and Q2Q4 can be identified as trade creation effect || and the remaining quantity imported Q1Q2 is the trade diversion effect.

Before the formation of the customs union, the payment for importing Q1Q2 quantity was Q1EFQ2. Out of it the revenue receipts to the government of the home country amounted to(P2P4 x Q1Q2 = EMNF). So the actual payment to country C for the import of Q1Q2 quantity of watches was Q1MNQ2.

After the formation of the customs union, the same quantity Q1Q2 is being imported from the partner country B on account of trade diversion. Since no tariff is applicable to B, the total payment to it due to import amounts to OP3 x Q1Q3 = KQ] x Q1Q3 = QiKLQ$_2$. Thus there is a larger external payment for importing the same quantity after the formation of the customs union to the extent of Q]KLQ$_2$ - Q1MNQ2 = KMNL which is shown through shaded area in Fig. This represents a loss or reduction in welfare. From this it follows that trade diversion causes a reduction in welfare. The simple reason for the decline in welfare is that the imports

are made from less efficient (high cost) partner country B rather than more efficient (low cost) non-member country C.

Net Welfare Effect of Custom Union

The trade creation results in an increase in welfare. It is depicted by areas AEKG and AFLH in Fig.1 The trade diversion, on the contrary, causes a reduction in welfare. In Fig. 1, ithas been shown by the area KMNL. Therefore the formation of customs union may either causea net increase or reduction in welfare. t

(J) If KMNL = (AEKG + AFLH), there is neither an increase nor a decrease in net welfare (H) If KMNL < (AEKG + AFLH), the formation of customs union results in a net increase in welfare of the home country A.

(Hi) If KMNL > (AEKG + AFLH), the formation of customs union leads to a net loss in welfare in country A.

2.5.4. General Equilibrium Approach to Customs Union

Jacob Viner's partial equilibrium analysis, based upon trade creation and trade diversion effects, is undoubtedly useful but is only of elementary character. The writers like R.G. Lipsey and J. Vanek have analysed the theory of customs union in the general equilibrium framework.

Lipsey Model of Customs Union

In the partial equilibrium approach, Jacob Viner pointed out that trade diversion causes a loss in welfare. This assertion of Viner came to be criticised at the hands of J.E. Meade, F. Gehrels and R.G. Lipsey.In their opinion, Vinerian conclusion can be valid only if it is assumed that the commodities are consumed in a fixed proportion and substitution effect is not present.

Assumption :Lipsey began by demonstrating that Viner's assertion can be valid under the following assumptions :

(i) There are three countries: A, B and C. Country A is the home country, country B is the member or partner country and country C is a non-union member country.

(ii) There are two commodities, X and Y.

(iii) Country A specialises completely in the production of X-commodity.

(iv) Commodity Y is imported from some foreign country.

(v) The two commodities are consumed in some *fixed proportion* irrespective of structure of relative prices.

(vz) The supply of the commodities is perfectly elastic.

(vii) The production takes place under the conditions of constant return to scale.

On the basis of these assumptions, Lipsey put Jacob Viner's model into a general equilibrium framework and proceeded to demonstrate that trade diversion can lead to a loss in welfare after the formation of customs union. This has been explained through Fig 2.

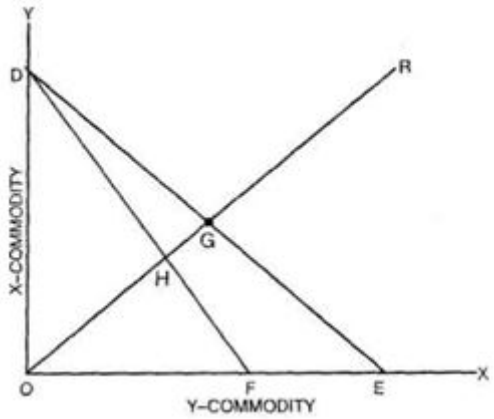


Figure: 2

In Fig. 2, commodity X is measured along the vertical scale and commodity Y is measured along the horizontal scale. The home country A specialises completely in the production of X commodity and production of X takes places at D. Country A imports OE quantity of Y from C in exchange of OD quantity of X. The line DE represents the best possible terms of trade available to country A before the formation of customs union.

Consumption takes place at G in a fixed proportion measured by the slope of line OR.

When customs union is formed, with country B, the trade gets diverted from C to B, the member country which is less efficient than country C. Now country A exports OD quantity of X commodity in exchange of OF quantity of Y commodity from partner country B. The terms of trade in this case are indicated by the slope of the line DF. It clearly shows that the terms of trade have got worsened for the home country A after the formation of customs union. Consumption still takes place in the fixed proportion on the line OR at point H. It means no substitution takes place despite relative change in price of two commodities. The point H is clearly inferior to the point G because it represents smaller amounts of both the commodities consumed. Thus Viner's assertion becomes valid that trade diversion results in a loss in welfare.

Lipsey, however, pointed out that J. Viner's assumption concerning consumption in fixed proportion is unrealistic. If this assumption is dropped, the trade diversion due to the formation of customs union can have two welfare effects opposite to each other. *First,* after the formation of customs union, country A will have to pay a higher price for commodity Y than before because the partner country B, from which import is being made, is less efficient than the non-member country C. *Second,* since no import duty is being paid on imports from country B, the domestic price of Y will fall bringing about increased consumption of Y due to its substitution for X. This may result in an increase in the welfare in country A. Given these two off-setting effect whether customs union and consequent trade diversion will increase welfare or not can be explained through Fig. 3.

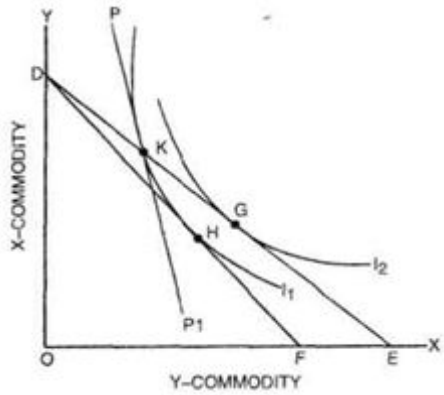


Figure: 3

In Fig.3, it is supposed that the home country A specialises completely in the production of X commodity and it originally imports OE quantity of Y from the most efficient country C in exchange of the export of OD quantity of X. The line DE represents the terms of trade for country A. These are the best possible terms of trade because country C is the cheapest source of supply of the commodity Y. G is the point of consumption where the line DE is tangent to the community indifference curve $\mathbf{I_2}$

Before the formation of customs union, as tariff is imposed by country A on Y commodity, the terms of trade line is now PP_1. It is tangent to the community indifference curve I_1at K. Since K lies on lower community indifference curve, there is loss in welfare after the imposition of tariff. The TOT at K are exactly the same as at G because both G and K lie upon the same line DE.

If a customs union is formed by A and B, there will be trade diversion. Country A will import Y commodity from the partner country B rather than the non-member country C. As OD quantity of X is exchanged with OF quantity of Y, the terms of trade are measured by the slope of the line DF. Since DF is tangent to the community indifference curve I_1 at H, this is the point of consumption after the customs union is formed. At H, the people in country A consume less quantity of X and more quantity of Y. It means there is substitution of Y in place of X. The level of satisfaction, however, remains the same because points K and H lie upon the same community indifference curve I_1. Thus Lipsey arrived at the conclusion

that there is reduction in welfare due to the formation of customs union and consequent trade diversion. Such a conclusion is quite contrary to what Jacob Viner had stated.

Criticism :Lipsey's general equilibrium model of customs union has been attacked by economists on the following grounds.

(i) Lipsey's refutation of the conclusion given by Jacob Viner rests upon the assumption that Viner's supposition of fixed proportion in consumption was invalid. According to Jagdish Bhagwati[8], the reduction in welfare is not necessarily because of the fixed proportions in consumption but it is because of Vinerian implicit assumption of a constant level of imports. When it is assumed that the volume of imports before and after the formation of customs union is unchanged, it must lead to the conclusion that trade diversion results in loss in welfare. But if the formation of customs union causes an increased volume of imports, there is likelihood that the net welfare remains constant or it rises compared to the pre-union situation.

(ii) Whether trade diversion causes a loss or gain in welfare or leaves it unaffected is conditioned by what happens to the terms of trade. If the deterioration in country A's terms of trade is such that there is a shift from DE to DF (as shown in Fig 3), the consumption equilibrium remains on the same community indifference curve I, and the level of welfare after the formation of customs union remains constant. In case deterioration in A's terms of trade is of a larger magnitude than indicated by the shift of line DE to DF, the post-union consumption equilibrium will be determined at a community indifference curve that lies to the left of I_1. Consequently, the customs union will cause a reduction in welfare. If the deterioration in the terms of trade is what causes a shift from DE to DF, the TOT line will lie somewhere between DE and DF. In such a situation, the consumption equilibrium will get determined at a community indifference curve higher than I_1. It will signify a gain in welfare after the formation of customs union despite trade diversion.

2.5.5. Dynamic Effects of Customs Union

The effects of customs union in the form of trade-creation and trade-diversion are of a static character. The static effects are basically concerned with reallocation of production and consumption. In fact the formation of the customs union initiates a process of structural and technical readjustments, on the one hand, amongst the member countries and, on the other, among the non-member countries. Such long-lasting dynamic effects of customs union have been greatly emphasised by the writers like T. Scitovsky, B. Belassa and W.M. Corden. The dynamic effects of customs unionareas follows:

(i) ***Increased competition*** : The most significant dynamic effect of customs union is the increase in intensity of competition within the union. Earlier in the sheltered markets, the monopolistic and oligopolistic industries had become sluggish and complacent. After the formation of customs union, as they are exposed to competition from rival firms with in the union, they have operated in the most efficient way or face the risk of elimination. All the firms, earlier operating below their optimum productive capacity, make efforts to expand production in order to cater to the demand from an expanded market and to minimise their costs. Competition also stimulates the managerial efficiency and induces the industries to utilize new technology. The custom union must take care that collusion and market-sharing arrangements, which had earlier restricted competition at the national level, should not restrict competition at the union level. In this direction, the member countries should enforce anti-trust legislation throughout the customs union.

(ii) ***Economies of scale*** : When a customs union is formed, expansion in the size of market, increased competition, increased specialisation and consequent enlargement of plant size lead to the emergence of internal and external economies of scale. This is evident from the experience of the countries of European Community (EC). The formation of EC resulted in economies of scale due to reduction in the range of differentiated products, increase in production run, pooling of skilled labour, capital resources, research and management.

(iii) ***Stimulus to investment*** : The expansion of market and more intensified competition stimulates investment activity. The need for introducing new techniques and accelerated depreciation of the existing plants and equipments step up greatly the rate of investment. In addition, there is also strong stimulus to foreign investment. Many non-member countries set up their plants in the territory of union members so that their products can evade the tariff barriers. Such industrial units are called as *tariff factories.* The massive United States investments in Europe after 1955 were probably on account of the American desire of not to be excluded from the rapidly expanding market of EC.

(iv) ***Movement of productive factors*** :After the formation of customs union, or more particularly, the common market, there is free movement of labour, capital and enterprise within the entire region of the common market. This ensures the optimal utilization of resources, increase in factor productivity and consequent rise in the growth rate of the economies of all the countries in the union.

(v) ***Technological advance*** : As a customs union is formed expansion in the size of market, greater competition, need for increasing the scale of production and achieve higher factor productivity, make the firms and industries develop very strong urge to imitate, to innovate and to make commercial application of technical, scientific and managerial innovations. There is strong stimulus to research for making improvements in the production techniques, processes of production and quality of products. The intense technological developments tend to push up the rate of economic growth.

(vi) ***Improvements in the terms of trade*** : The formation of the customs union results in raising of external tariffs against the outside world and consequent reduction in imports from abroad. This tends to raise the bargaining power of the union members against the rest-of-the world. The improvement in the terms of trade brings about also an improvement in the balance of payments position of the member countries.

(vii) Reduction of risk and uncertainty :The foreign transactions often involve high degree of risk. The complexity of trade regulations, unilateral changes by countries in the tariff and non-tariff trade restraints and foreign exchange regulations create much uncertainty. The economic integration reduces to a significant extent, risk and uncertainty particularly in respect of the inter-member transactions.

2.5.6 Short answer type questions

Write short notes on:

1. Custom Union
2. Trade creation
3. Trade diversion
4. Effects of custom union

2.5.7 Long answer type questions

1. Explain static and dynamic effects of custom union.

2. Explain general equilibrium approach of custom union.

2.5.8 Recommended Books

1. Sodersten, Bo and Read, G. : *International Economics*
2. Salvatore, D. *: International Economics*
3. Ethier, W.J. : *Modern International Economics*

M.A. (Economics) Part-II **Paper- 304-305 (Option-I)**
International Economics

Lesson No. 2.6

United Nations Conference on Trade and Development (UNCTAD)

INTRODUCTION

The United Nations Conference on Trade and Development (UNCTAD) was established in 1964 as a permanent intergovernmental body, UNCTAD is the principal organ of the United Nations General Assembly dealing with trade, investment and development issues, aims at the development-friendly integration of developing countries into the world economy. UNCTAD is the focal point within the United Nations for the integrated treatment of trade and development and the interrelated issues in the areas of finance, technology, investment and sustainable development. UNCTAD is a forum for intergovernmental discussions and deliberations, supported by discussions with experts and exchanges of experience, aimed at consensus-building. UNCTAD undertakes research, policy analysis and data collection in order to provide substantive inputs for the discussions of experts and government representatives. UNCTAD, in co-operation with other organizations and donor countries, provides technical assistance tailored to the needs of the developing countries, with special attention being paid to the needs of the least developed countries, and countries with economy in transition.

ORGANISATION AND FUNCTIONS OF UNCTAD

Currently, UNCTAD has 191 member States and is headquartered in Geneva, Switzerland. UNCTAD has 400 staff members and an annual regular budget of approximately US$50 million and US$25 million of extra-budgetary technical assistance funds.

The U.N. General Assembly declared in December 1961 that 1960's would be the development decade. It was the recognition of the need for adopting measures to bridge up the trade and technological gaps between the rich and the poor countries of the world. In July 1962, the developing countries at their Cairo Conference adopted "Cairo Declaration" and called upon the United Nations to convene an international conference on trade and development. The United Nations Economic and Social Council agreed to convene such a conference and passed a resolution to this effect on August 3, 1962. The United Nations General Assembly endorsed it in its resolution of December 8, 1962. It was on the recommendation of the United Nations Economic Council in July 1963 for convening a conference on trade and

development that the United Nations Conference on Trade and Development (UNCTAD) was set up in 1963 as a permanent organ of the UN General Assembly. It also defined the functions, activities and membership of the UNCTAD. All these developments resulted in the convening of the United Nations Conference on Trade and Development in Geneva from March to June 1964.

The UNCTAD has been set up as a permanent organ of the UN General Assembly. It has its own structure of subsidiary bodies and a full time Secretariat. It has instituted a Trade and Development Board and takes policy decisions when the conference is not in session. It is composed of 55 members, elected by the conference from among its members on the basis of equitable geographical distribution. The meeting of the Board takes place twice a year. The Trade and Development Board is assisted in its functions by four subsidiary committees. These include committees on commodities, manufactures, shipping; and invisible items and financing related to trade.

The meeting of these committees generally takes place once a year but the special session of committees can be convened to deal with the matters of urgent nature. All the members of the United Nations are eligible for the membership of the UNCTAD.

FUNCTIONS

The essential purpose of instituting UNCTAD was to promote accelerated development of the less developed regions of the world by dealing properly with the problem of slow expansion of exports, persistently increasing BOP deficits, burden of external debts etc. confronting the LDCs. The organization's goals are to "maximize the trade, investment and development opportunities of developing countries and assist them in their efforts to integrate into the world economy on an equitable basis." (from official website). The creation of the conference was based on concerns of developing countries over the international market, multi-national corporations, and great disparity between developed nations and developing nations.

Basic Principles: The UNCTAD I held in 1964 specified that action programmes and priorities of the UNCTAD would be based upon the following basic principles:

I. Sovereign right of each member country to dispose of freely its natural resources in interest of its development, well-being of its population and furtherance of KS trade with other countries.

II. International economic and trade relations shall be based on such principles as respect for sovereign equality of states, self-determination and non-interference in the internal affairs of the others.

III. No discrimination among member countries on account of differences in socio-economic system and independent pursuit of economic and other policies.

IV. Extension of preferential concessions,

V. Greater market access for the products of the less developed countries.
VI. Reduction in tariff and non-tariff restrictions on trade.
VII. Unconstrained flow of international aid.

MEETINGS OF UNCTAD

The inter-governmental work is done at 4 levels of meetings: The UNCTAD Conference - held every 4 years; The UNCTAD Trade and Development Board - the Board manages the work of UNCTAD in between two Conferences and meets up to three times every year; Four UNCTAD Commissions and one Working Party - these meet more often than the Board in order to take up policy, programme and budgetary issues; Expert Meetings - the Commissions will convene expert meetings on selected topics in order to provide substantive and expert input for Commission policy discussions.

In pursuit of its objectives and functions, there have been so far ten meetings of the UNCTAD. A brief resume of these UNCTAD meets has been given below:

***UNCTAD I*:** The UNCTAD I was held at Geneva from March 23 to June 16, 1964. This conference was attended by the delegates from 120 countries, 32 non-government bodies and 13 specialized agencies. The conference laid down certain important directive principles such as economic development and social progress should be the concern of entire international community; greater market access for the products of LDCs; extension of preferential concessions, both tariff and non-tariff, by the developed counties; unconstrained aid flow and ; the international economic relations to be based upon the principle of equality and non-intervention. The UNCTAD I could not achieve anything tangible except the exchange of ideas and projection of needs of the LDCs. In this regard Raul Prebisch commented, "Nothing in the field of action but a considerable advance in the field of ideas".

***UNCTAD II*:** The UNCTAD II was held at New Delhi between February 1 to March 30, 1968. It was attended by the delegates from 121 countries. The UNCTAD II deliberated upon trends and problems in global trade and development, commodity problems and policies of different countries, aid and development finance to the developing countries, expansion and diversification of exports of manufactured and semi-manufactured goods of the developing countries, problems of developing countries related to services such as shipping etc., problems and measures for economic integration and expansion of trade among the developing countries and general review of the work and functions of the UNCTAD. The conference did not result in concrete agreements on the most of controversial issues and developing countries felt greatly disappointed by the non-committal of developed nations on aid flow and access to their markets.

***UNCTAD III*:** The UNCTAD III was held from April 13, 1972 to May 17, 1972 at Santiago in Chile (South America). It was attended by the delegates from 99

countries. The key issues discussed at the meet included the link between Special Drawing Rights (SDR's) and development finance, access to the markets of developed countries, price policy for primary products, special measures for the development of the least developed countries and international code of conduct for liner conferences. The conference could achieve very modest gains including the unanimous decision to adopt special measures for the development of 25 least developed countries, decision related to assistance to land-locked countries and the decision about the code of conduct concerning shipping. On the whole, the developing countries came back from the conference in despair and frustration.

UNCTAD IV: The UNCTAD IV was held at Nairobi (Kenya) from May 3 to May 31, 1976. It was attended by the representatives from 153 countries and those of specialized agencies, inter-governmental and private organizations. Some of the results that emerged from Nairobi meet included the agreement on common fund for buffer stock financing, integrated commodity programme, extension of the term of Generalized System of Preferences beyond the original envisaged term of 10 years, holding of multilateral trade negotiations at Geneva to lift or reduce trade barriers on exports from less developed countries, export credit financing, transfer of technology, assistance to land-locked countries and strengthening of UNCTAD. The Nairobi conference although did not fully come upto the expectations of the LDCs, yet it was not completely an exercise in futility as the earlier conferences.

UNCTAD V: The UNCTAD V was held in Manila, Philippines between May 7, 1979 and June 3, 1979. It was attended by 150 delegates from the member countries and the international organizations. The agenda of UNCTAD V included such issues as the developments in international trade of commodities, manufactures and semi-manufactures, monetary and financial issues of transfer of technology, shipping, issues related to the least developed countries and land-locked countries, trade relations among countries having different economic and social systems, international economic co-operation and institutional issues. The sharp differences continued to remain on most of the core issues between the developed and the less developed countries. A consensus could be reached at the conference on the transfer of resources to developing countries, practices of transnational corporations, protectionism, strengthening of technical capacities in the developing countries, reverse transfer of technology, brain drain, commodities, industrial property system and convention on a code of conduct for shipping conferences. The consensus resolutions related to the assistance to the least developed countries, land-locked countries and island countries were also carried. The conference, however, failed to produce any agreements on such vital issues as the monetary reforms, a proposed complementary financing facility for the stabilization of commodity export earnings and the international debt

problem. In the 1970s and 1980s UNCTAD was closely associated with the idea of a New International Economic Order (NIEO).

***UNCTAD VI*:** The UNCTAD VI was held in Belgrade, Yugoslavia in June, 1983. It was attended by 165 delegates from the member countries and international bodies. The less developed countries raised the issue of mounting trade deficit of LDCs *vis-à-vis* developed countries and called upon the latter to lower the walls of protectionism and to expand the Generalized System of Preferences. *Secondly,* the less developed countries, in view of persistent fall in the prices of their export products-and adverse-terms of trade, pressed for the speedy creation of common fund for financing the international buffer stocks of different commodities that had been covered under the United Nations Integrated Programme for commodities. *Thirdly,* the less developed countries brought into focus the problem of mounting burden of external debts. In case of several developing countries, it had already gone beyond their repaying capacity. The LDCs wanted the Official Development Assistance (ODA) to be raised from existing 0.3 per cent of 0.7 per cent of the GNP of developed countries as per the UN Resolution. They also wanted the facility of debt rescheduling and conversion of loans into grants in the case of the least developed countries. The developed countries agreed to consider debt problem only on a bilateral basis. The LDCs, on the opposite, stressed upon some multilateral arrangement in this regard. The demand was also raised that there should be structural reforms in the World Bank and IMF so that the voice of the less developed world is better heard by them. No significant progress could, however, be made in respect of the vital issues raised by the poor countries at this conference.

UNCTAD VII: The UNCTAD VII was held at Geneva in July-August 1987. It was attended by delegates from over 150 countries and international bodies. The main issues that were discussed at the conference included debt burden of developing countries, growing trend of protectionism in international trade, improvement of economic and social conditions in the least developed countries and commodity assistance to the LDCs. The UNCTAD VII failed to yield any tangible results except an agreement among the developed and poor countries on the Integrated Commodity Programme (ICP) which had although been launched in 1976, yet proved to be a non-starter. UNCTAD VII at last could lead to the recognition of the necessity of such a programme. This agreement was the only achievement of this conference and was expected to pave the way for more commodity agreements. Otherwise the UNCTAD VII was quite disappointing.

UNCTAD VIII: The UNCTAD VIII was held at Colombia from February 8, 1992 to February 25, 1992. It was attended by 170 delegates from the member countries and the international agencies. Unlike the earlier UNCTAD meets, when the developed and under-developed countries stuck to their respective rigid and

conformationist positions, the UNCTAD VIII was characterized by a remarkable unity of action and the atmosphere was generally constructive, positive and non-confrontationist. The Secretary General of the UNCTAD claimed that the meet had given a turning point to the history of the conference. The UNCTAD VIII gave common approaches to themes of international economic agenda of 1990's.

***UNCTAD IX**:* The UNCTAD IX was held in Midrand, South Africa in 27 April – 11 May 1996. UNCTAD IX has responded to these changes and challenges by initiating important reforms designed to give new and real meaning to the partnership for development. The economies continue to be unified by flows of trade, finance, information and technological change. This increased interdependence is a powerful impetus to liberalization of these flows. Competitive pressure on all economies has increased, and market forces play a pivotal role. The rules- based system of the WTO will facilitate positive integration of countries into the global trading system if the commitment to this objective is strengthened.

The countries enter this system from very different starting points. Accordingly, the impact of globalization and liberalization is uneven. There are notable developing country successes where domestic reforms have provided increased dynamism to international trade and investment. Yet there remain problems of access to markets, capital and technology, and many grapple with the institutional transformation necessary for meaningful integration into the world economy.

The least developed countries (LDCs), particularly those in Africa, and other developing countries remain constrained by weak supply capabilities and are unable to benefit from trade. Marginalization, both among and within countries, has been exacerbated. Too many people continue to live in dire poverty. As we near a new millennium this is an intolerable situation.

It is in the interest of all countries that a mutually beneficial multilateral trading system continues to develop. This requires the recognition of differential impacts on countries and the solidarity necessary to ensure that all will benefit - a true partnership for development.

The partnership for development must be based upon a clear definition of roles, the establishment of common objectives and development of joint action. In practical terms this means:

(i) Strengthening intergovernmental cooperation between developed and developing countries;

(ii) Cooperation between developing countries should be enhanced with special attention to LDCs;

(iii) More effective coordination and complementarily of multilateral institutions;

(iv) The mobilization of human and material resources towards development through dialogue and common action between Governments and civil society;

(v) Partnerships between the public and private sector to achieve higher growth rates and greater development.

Institutional reform of UNCTAD

The comprehensive United Nations reform process is designed to refocus and reinvigorate international cooperation for peace and development. UNCTAD IX and the Secretary-General of UNCTAD have made a significant contribution to this process through the comprehensive changes that have been adopted. These changes support the more focused work of UNCTAD through streamlining the intergovernmental machinery, improving the method and quality of expert input and focusing and integrating the secretariat's working methods. The results of these changes must be outputs that respond to the needs and demands of the member States.

The Conference also agreed on major institutional reform of the organization in order to focus its work on a few priority trade and development issues of central importance on which it can make a substantial impact on people´s lives in developing countries, including the least developed among them.

UNCTAD IX undertook a restructuring of UNCTAD´s intergovernmental machinery. The Trade and Development Board, the executive body of UNCTAD, is responsible for ensuring the overall consistency of UNCTAD´s activities. It meets once a year in regular session, in the autumn to deal with interdependence and global economic issues from a trade and development perspective. It also reviews progress in the implementation of the Programme of Action for the LDCs and of the United Nations New Agenda for the Development of Africa, with attention given to the examination of policy lessons drawn from successful development experiences.

The Board can meet in one-day executive sessions three times throughout the year to deal with policy as well as management and institutional matters.

The following three subsidiary bodies of the Trade and Development Boardwere also established:

- Commission on Trade in Goods and Services, and Commodities;
- Commission on Investment, Technology and Related Financial Issues;
- Commission on Enterprise, Business Facilitation and Development.

The Commissions perform integrated policy work in their respective areas of competence. They meet once a year unless otherwise decided by the Board. Each Commission may convene expert meetings of short duration (maximum three days). The total number of expert meetings will not exceed ten per annum.

An important decision taken by the Conference is that interests of developing countries should be taken into account in the built-in future work programme contained in the various Uruguay Round Agreements and the key new emerging issues.

UNCTAD has been entrusted with policy analysis from a development perspective on topics on the international trade agenda, including new and emerging ones. This will help to build consensus and to bring to bear the interest of developing countries on issues before they enter the international agenda for negotiation in WTO.

UNCTAD is called upon to improve the general understanding of trends in FDI and to analyze "implications for development of issues relevant to a possible multilateral framework on investment", bearing in mind the work undertaken by other organizations, such as the OECD.

Competition is seen as an important new policy area. Relevant to this is UNCTAD´s work on restrictive business practices. UNCTAD is requested to examine issues related to competition law of particular relevance to development.

UNCTAD is called upon to analyze issues concerning environmental policies and measures, in particular competitiveness, market access, eco-labelling, multilateral environmental agreements, positive measures, and trade liberalization and sustainable development. In the above areas, UNCTAD is also requested to provide practical assistance and policy advice. The Conference agreed that UNCTAD should continue to facilitate the integration of developing countries and countries in transition in the international trading system. Its work should be action-oriented and provide guidance on national policies, with a special focus on the LDCs.

UNCTAD X: The UNCTAD X was held in Bangkok, Thailand in 12-19 February 2000 Proposals on LDCs. Instructed by his own intergovernmental board to patch up strong differences evident in Seattle between the industrialized and developing countries, WTO Director-General Mike Moore arrived in Bangkok with a four-part package of proposals designed to assuage the South. He told the conference that development is a major concern of the WTO's post-Seattle work programme. He called for duty- and quota-free access to Northern markets for all exports from the world's 48 least developed countries (LDCs) -- 33 of which are African. He urged industrialized countries to fund technical assistance to help developing countries implement agreements made in the Uruguay Round of trade talks, which concluded in 1995 with the formation of the WTO. The current WTO technical assistance budget is less than $1 mn.

The third element of the package provides for an extension of transition periods to enable developing countries to implement the liberalized trade measures contained in the Uruguay Round rules governing world trade. Many of these

"special and preferential" provisions expired in December 1999 and probably would have been extended in Seattle if not for the failure of the talks. Finally, Mr. Moore pledged greater transparency in WTO operations.

UNCTAD XI: The UNCTAD XI was held in São Paulo, Brazil in 13-18 June 2004. UNCTAD´s eleventh session ended with the adoption of the São Paulo Consensus, which once again places UNCTAD at the centre of the trade and development debate.

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The official conference theme was "Enhancing coherence between national development strategies and global economic processes towards economic growth and development, particularly of developing countries".

This focus on coherence was examined from the following four angles, each one corresponding to a subtheme: development strategies in a globalizing world economy; building productive capacity and international competitiveness; assuring development gains from the international trading system and trade negotiations; and partnership for development.

The outcome of the negotiations is contained in the São Paulo Consensus [PDF]. For each sub-theme it identifies problems, formulates appropriate national and international responses and spells out how UNCTAD can contribute. It builds on the Bangkok Plan of Action adopted at UNCTAD X in February 2000 and introduces a number of new areas of work.

Global System of Trade Preferences

An important outcome that strengthens solidarity among developing countries was the new impetus given to the (GSTP) among developing countries. A new round of negotiations will start in November 2004 and is scheduled to last two years.

UNCTAD XII will be held in Accra, Ghana in 21-25 April 2008

INTEGRATED PROGRAMME FOR COMMODITIES

The most fundamental issue from the point of view of less developed countries right from the institution of UNCTAD has been one related to the trade in primary products. While the LDCs at the UNCTAD meet have been persistently asking for greater market access for the traditional items of exports of the poor countries, the advanced countries showed little inclination to do so. They continued to adopt protectionist policies and restricted the product flow from the poor countries through both tariff and non-tariff barriers. The processed products were subjected to stiffer restrictions than the unprocessed products. Other serious issues pertaining to the exports of primary products had been wide fluctuations in the volume of their exports, decline in their international prices

and consequent continual deterioration in the terms of trade of primary goods of the developing countries relative to the manufactured goods of the developed countries.

GENERALISED SYSTEM OF PREFERENCES (GSP)

The stability of prices of primary products is necessary from the viewpoint of the LDCs but it is not sufficient. In order to enlarge their export earnings, to promote their industrialization and to step up their growth rates, these countries urged upon the developed countries to give tariff preferences on their manufactured and semi-manufactured products.

The Group of 77 less developed countries (G 77) first of all broached this issue and brought it before the UNCTAD-I in 1964. The proposal for the Generalized System of Preferences (GSP) was based on the principle that the less developed countries needed the preferential tariff treatment without reciprocity on their part rather than the most-favoured nation (MFN) tariff cuts. Although MFN tariff cuts did not discriminate between the same product exported from different sources, the exports of manufactured industrial goods from the LDCs faced, on average, higher tariff than those exported by the advanced countries. It is on account of the fact that the LDCs do not have the capacity to follow the principle of reciprocity m tariff cuts. In addition, the GSP was intended to counter the disadvantage faced by them due to regional economic groupings like the EC. The negotiations on GSP system continued over 1964-71 period. At the UNCTAD II held at New Delhi in 1968, the member countries unanimously agreed for the early establishment of a mutually acceptable system of generalized, non-reciprocal and non-discriminatory preferences.

A waiver to MFN clause was approved by the GATT in June 1971. It allowed the developed countries to accord more favourable tariff treatment to commodities imported from the developing countries for a period of 10 years .-The first scheme related to GSP was implemented by the EC in 1971. It was followed by Japan, Australia, New Zealand and Canada between 1972 and 1974. The United States' scheme did not come into operation until January, 1976.

The effectiveness of any GSP scheme is determined by a host of factors such as the extent of tariff cuts, product coverage, escape clauses, rules of origin and beneficiary countries.

(i) ***Extent of tariff cut*:** Under the GSP a large number of manufactured and semi-manufactured goods from the LDCs receive preferential treatment. These products either enjoy tariff reduction or exemption. There are low preferential margins in case of raw materials and semi-manufactured goods. In case of manufactured products, the preferential margins are relatively high. The preferential margins vary from 4 per cent to 50 percent compared with the duty structure under MFN.

(ii) ***Product coverage:*** The products which are covered by the GSP differ from country to country. The efforts continued during 1970's to expand the product coverage under this system. A 1983 study published by the Organization for Economic Co-operation and Development showed that the product coverage under the GSP was upto 56-4 per cent in agricultural sector and 90-3 per cent in the industrial sector.

(iii) ***Escape clauses:*** The different GSP schemes include escape clauses under which the developed countries can reduce the quantities imported or withdraw tariff concessions under certain circumstances. The preferences can be withdrawn, if a given beneficiary of preferences exports the products above a specified limit. The concessions may also be withdrawn by the concession-giving country, if the national interests of the importing country get damaged through preferential imports.

(iv) ***Rules of origin:*** A necessary qualification for availing of the GSP benefits by the LDCs is that the commodities should be either wholly or substantially produced within the country of origin. In this connection, the different GSP schemes have different conceptions related to the country of origin and to the extent upto which the goods should be of indigenous origin. The GSP schemes generally have a value-added criterion such as 35 per cent to 50 per cent of value added should be within the exporting beneficiary country. If the imported components in the exported commodities are substantially obtained from the preference-giving country, the preference may become invalid and may be withdrawn.

(v) ***Beneficiary countries:*** The different GSP schemes have specified the countries to be benefitted by the preferences. Generally all the LDCs are covered but certain conditions have been specified. For instance, in the United States GSP scheme, the OPEC countries are excluded. Similarly, the countries which are not the members of IMF or WTO are rendered ineligible for preferential treatment. A country having economic or financial disputes with the preference-giving country also renders itself ineligible for preferences. In the same way, the countries which grant reverse preference to some other countries are also excluded from the GSP schemes.

Originally the GSP schemes were enforced for a period of 10 years starting from 1971. A review of the GSP was made by UNCTAD in 1980. As it was found that the objectives had not been fully realized, the decision was made to extend the system further. Accordingly the GSP was extended in 1981 for another term of 10 years.

The system of Generalized Preferences suffers from certain limitations:

(i) ***Off- setting effect of OPEC policies*****:** It must be admitted that the GSP resulted in substantial expansion of trade between 1971 and 1980. There

was some setback in the exports of LDCs in the 1980-82 and 1983-84 on account of global recession. After 1985, there has been recovery in export prices of manufactured goods. The policies pursued by the Organization of Petroleum Exporting Countries (OPEC) have, however, created a serious off-setting effect since the mid 1970's. They have been charging excessively high oil prices even from the LDCs. Such policies have greatly worsened their balance of payments deficit and increased considerably the burden of external debts apart from intensifying the inflationary pressures and obstructing their process of development.

(ii) ***Limited coverage*** **:** A serious limitation of GSP schemes is that they do not provide coverage to all the exportable goods of the LDCs. One of the principal exports of several LDCs has been the textiles and clothing. The United States and Japan have excluded outright these products from the GSP. The EC, on the other hand, offers only preferential treatment to countries that abide by 'voluntary export restraints'. There are also limits on the value of imports that can receive GSP tariff treatment.

(iii) ***Less benefit relative to MFN tariff cuts*** **:** The limits placed by the advanced countries on the eligibility of the products for GSP treatment have clearly restricted its benefits. Many writers hold the view that the LDCs are likely to gain more from the MFN tariff cuts than they would lose from the simultaneous erosion of their GSP preferential tariff margins. Unless there is relaxation in the area of agricultural and fishery products, processed agricultural goods and resource-based traditional manufactures, the GSP is not likely to have desired beneficial effects on the exports of less developed countries.

(iv) ***Benefits to more advanced developing countries*** **:** The GSP schemes have rendered benefits mainly to the more advanced among the developing countries. The study made by Baldwin and Murray showed that more than three quarters of the trade of the LDCs involved only eleven more advanced developing countries. The position remained generally unchanged even in the subsequent period because the products covered by the GSP are largely produced by these few countries.

(v) ***Opposition by advanced countries :*** Although the leading advanced countries have carried the GSP now for more than two decades, yet there is sustained opposition and resentment against the system of preferences. Even a prominent economist like Martin Bronfebrenner has commented on the GSP in very harsh words. According to him, "UNCTAD or GSP preferences or similar conferences are anti-capitalist and anti-market. Members of the 'Group of 77' enter into cartel arrangements of OPEC variety and yet demand concessions from the developed countries. There

is conspiracy to rob the rich at the UNCTAD conferences." In this regard it must be stated that the advanced countries themselves never followed the rules of market system. They prescribed and preached others to follow the free trade and market system but themselves created high tariff and non-tariff walls and entered into cartel and custom-union arrangements. They want free access to the markets of the LDCs without permitting the corresponding facilities to the latter.

(vi) *Graduation from the GSP*: The USA has been following a policy of 'graduating' the beneficiaries from the GSP scheme. The preferences are withdrawn if the USA thinks that a less developed country is no longer less developed. For it, the reliance is placed upon the faulty criterion of the GNP rather than the per capita income. USA and other advanced countries remove a number of commodities arbitrarily from the preference list. There should be certain norms on all these matters enforceable by the UNCTAD, if the GSP schemes are to become instruments for the expansion of international trade and acceleration of growth process.

The GSP can achieve its objectives in a satisfactory manner only if necessary modifications are made in the areas of product coverage, reduction of tariffs, rules of origin and removal of quota restrictions.

INTERNATIONAL QUOTA AGREEMENTS AND MLTTILATERAL CONTRACT SYSTEM

International commodity agreement may sometimes be of the form of the international quota agreement and the multilateral contract system.

In the case of *international quota agreements,* the ceiling and floor prices are specified. The quotas are fixed for either production or exports in the producing countries and for imports in the consuming countries. As the prices tend to move outside the agreed band, these are sought to be kept within the specified limits through the operation of quotas. If the price falls below the specified minimum, the quotas are imposed on the producing countries. On the opposite, if the price moves above the specified ceiling, then a quota of imports is enforced upon the importing countries.

In the case of *multilateral contract system* too. the maximum and minimum prices are specified. Along with that there are contracts among countries to buy or sell specified quantities of a given product. If the market price goes beyond the maximum limit, producers' contracts to sell are invoked. On the other hand, consumer's contracts to buy are invoked in the event of price falling below the floor level or upto floor level. The International Wheat Agreement of 1949 was of the type of multilateral contract agreement. It subsequently underwent a sense of modifications. No doubt the above two forms of agreements can provide some measure of security to both consuming and producing countries but they have

not proved very successful.

COMPENSATORY FINANCE SCHEMES

At the 1964 UXCTAD meet, an important development was the multilateral compensator. finance scheme proposed by James Meade. The essence of the scheme is the designation of -'normal'-volume of imports for each importing country. A 'standard' price is agreed upon. If the actual price falls below the standard price, the importing countries are required to pay compensation to the producing or exporting countries computed on the basis of standard price and normal volume of imports. If the actual price exceeds the standard price, the compensation is paid by producing countries to the importing countries. The major difficulty connected with compensator, finance scheme is the forecasting of price correctly. If the price is set at too high a level, it will result in a large transfer of resources from the industrial to primary-producing countries. On the opposite, if the price is set too low, the scheme will result in the transfer of resources from primary-producing less developed countries to the industrial countries.

The most important compensatory financing scheme has been the Compensatory Financing Facility (CFF) introduced by the IMF in 1975. Under the scheme, the countries in case of which export earnings decline, can have access to easy loans. The current earnings are compared with the average of earnings in the current year, two previous years and forecasts of earning m two following years. The countries requiring compensation facility are required to satisfy certain conditions laid down by the IMF : The shortfall in export earning was not due to the fault of the exporting country, It is faced with balance of payments deficit. It is willing to cooperate with the IMF in finding a solution to the problem. The borrowing must not exceed the specified maximum limit for that country.

FLOW OF DEVELOPMENT FINANCE

The less developed countries right from the time of UNCTAD-I have been pressing for increased flow of development finance. They require a large flow of "capital from advanced countries for financing their development programmes; for off-setting persistent balance of payment deficits and; for the servicing of their outstanding international debts.

In view of the acute shortage of development finance faced by the LDCs. a resolution was passed at the UNCTAD III held in May 1972 urging upon the IMF to link up the Special Drawing Rights (SDR's) with the development assistance. Apart from this, the UNCTAD III called upon the LMF to institute a committee for monetary reforms. The LDCs at this UNCTAD meet raised the demands related to the close examination of relationship between the development assistance and indebtedness. It was also stressed that one percent target of development assistance should be exclusive of private investment and credits

from suppliers and purchasers. But the Conference did not bring any tangible result. Even at UNCTAD IV held at Nairobi in May 1976. three resolutions were passed concerning debt problem of LDCs. improvement in the working of IMF in relation to developing countries and large concessional aid to them with the object of achieving 0.7 per cent target of development assistance by the developed countries. The Manila meet of UNCTAD V held in 1976 passed a series of resolutions related to increase in IMF quotas of the LDCs. flexible approach in the application of IMF conditionality to these countries, improvement in the terms and use of extended fund facility, improvement and liberalization of the existing compensatory facility and interest subsidy account for the developing countries. To enable the LDCs to overcome their mounting debt problems, an *ad hoc* inter-governmental group of experts was set up by the Conference for suggesting appropriate reforms in the area of international debts. In the Belgrade meet of UNCTAD VI in June 19S3, the resolutions related to development assistance by developed countries upto the target of 0.7 per cent of their GNP. rescheduling of debts and conversion of loans into grants in the case of the least developed countries had been passed.

UNCTAD MI held at Geneva in July-August 1987 too passed formal resolution related to the debts of developing countries and paucity of development assistance. The passage of resolutions had become a ritual and formality at the UNCTAD meets leading only to increased frustration among the developing countries. UNCTAD MU was preoccupied mainly with the issues of revitalization and restructuring of it. This conference provided for the creation *of ad hoc* working groups to deal with investment and financial flows, non-debt creating finance for development, new mechanisms for increasing investment and financial flows.

The impact of structural reform in the UNCTAD upon the trade and development can be judged only after the new structure is brought into operation. The experience of the developing countries over the last three decades has been extremely disappointing. The pious resolutions were treated with an abject indifference by the developed countries. In fact, over the years, the UNCTAD has lost initiative on trade to GATT and now to WTO; on development to the IBRD and on debt problems to the IMF. The UNCTAD has been virtually reduced to a mere forum for discussion.

TRANSFER OF TECHNOLOGY

It is an irrefutable fact that the sustained growth of a country, whether developed or underdeveloped, is contingent upon its technological development. Unless a country acquires the capability to absorb, adopt and apply the new production techniques, the self-sustained growth eludes. It was at the UNCTAD IV held at Nairobi in 1976 that the emphasis was placed upon the necessity of strengthening

of technological capabilities of the LDCs through training programmes, setting up of local and regional centres for the transfer of technology and creation of better research facilities within the LDCs. The conference provided for a group of experts for framing a code of conduct for the transfer of technology. The conference also called upon the advanced countries to revise the international patents system. The UNCTAD V at its meet in Manila in May 1979 passed a consensus resolution on transfer of technology to the LDCs. strengthening of their technological capacities, reverse transfer of technology and brain dram.

The issue of technological transfer was re-emphasized at UNCTAD VI held at Belgrade in June 19S3. The UNCTAD took note of the fact that the technological gap between the developed and less developed nations was getting more and more widened. The quick technological transformation of the LDCs requires the reduction in external technological dependence and strengthening of their autonomous, indigenous technical development. The strategy for technical transformation, as outlined by the UNCTAD Secretariat in a study paper and presented at the Belgrade conference, stressed upon processing of primary products, diversification of products and creation of indigenous research and training centres to create capacities in the LDCs to produce the required capital goods and to generate advanced technical skills. The UNCTAD VIII at its meet in Colombia in February 1992 stressed upon inter-relationship between investment and technical transfer and instituted an *ad hoc* working group to deal with this matter.

There is little doubt about the need of technology transfer for industrialization and economic self-reliance but the insistence of the advanced countries on the protection of their intellectual property right and consequent rise in the cost of technological transfer is likely to act as a major barrier to the growth of indigenous research and technological development in the poor countries. The UNCTAD should address itself to this problem with greater earnestness to ensure a free access of the LDCs to the sources of technical know-how and to cut down barriers to the transfer of technology.

ACHIEVEMENTS OF UNCTAD

The UNCTAD meets contributed in evolving integrated programme for commodities for the stabilization of prices of primary products. The deliberations at UNCTAD meets resulted in the schemes of Generalized System of Preferences (GSP) adopted by EC, Japan, Canada, Australia and United States to benefit the LDCs. The UNCTAD could bring into existence the international buffer stock agreements for supporting and stabilizing the prices of primary products. As a result of UNCTAD discussions, the bilateral and multilateral price compensation agreements, quota agreements and contract agreements were brought into operation. The compensatory finance schemes could be evolved by the IMF and EC on account of various UNCTAD meets. The different meets stressed upon

transfer of technology to UDCs strengthening of their technological capacities and creation of inter-relationship between investment and technological transfer.

FAILURE OF UNCTAD

The launching of the United Nations Conference on Trade and Development (UNCTAD in early 1960's rightly aroused high hopes and aspirations among the LDCs. They assumed that this organization would perhaps open up the gates of heaven for them. The functioning, rather non-functioning of UNCTAD, resulted in deep disillusionment and frustration among them.

The member countries of the UNCTAD. after regular intervals, go through some ritualistic movements and exercises which turn out to be futile. This forum has been frequently used botr. by the developed and LDCs for polemics and accusations rather than promoting fruitful cooperation and co-partnership among the two groups of countries. The continued stiff and unaccommodating attitude of the advanced countries and increasing economic difficulties of the LDCs have created so deep-rooted suspicions among the developed and the LDCs that there is little scope for any worthwhile progress in the direction or establishing a new international economic order. The UNCTAD had placed before itself some objectives which have generally eluded it so far.

Lesson No. 2.7

WTO and Indian Economy

2.7.1 Introduction

The birth of World Trade Organisation (WTO) on January 1, 1995 holds a great promise for the entire world economy in respect of international trade. This World Trade Organisation will administer the new global trade rules estal lishing the rule of law in international Trade, which amounted to nearly five trillion dollars goods and services. The latest issue of GATTAVTO News (January, 1995) observed that the new global trade rules were achieved after seven years of negotiations among more than 120 countries and through the WTO agreements and market access commitments, world income is expected to rise by over 500 billion dollar annually by the year 2005 and annual global trade growth will be as much as a quarter higher by the same year than it would have been otherwise.

2.7.2 Objectives of lesson

In this lesson we will discuss WTO and its impact on Indian economy.

2.7.3 Role of World Trade Organisation (WTO)

The World Trade Organisation (WTO) is playing an important role for administering the new global trade rules in the following manner:

(1) The WTO administers, through various councils and committees, the 28 agreements contained in the final act of the Uruguay Round, plus a number of plurilateral agreements, including one government procurement.

(2) WTO also oversees the implementation of the significant tariff cuts (averaging

40 per cent) and reduction of non-tariff measures agreed to in the trade negotiations.

(3) WTO is a watchdog of international trade, regularly examining the trade regimes of individual members. In its various bodies, members flag proposed or draft measures by others that can cause trade conflicts. Members are also required to notify in detail various trade measures and statistics, which are maintained by the WTO in a large data base.

(4) WTO provides several conciliation mechanisms for finding an amicable solution to trade conflicts that can arise among members.

(5) trade disputes that cannot be solved through bilateral talks are adjudicated under the WTO Dispute Settlement Court. Panels of independent experts are established to examine disputes in the light of WTO rules and provide rulings. This tougher streamlined procedure ensures equal treatment for all trading partners and encourages members to live upto their obligations.

(6) WTO is a management consultant for world trade. Its economists keep a close watch on the pulse of the global economy and provide studies on the main trade issues of the day. The secretariat assists developing countries in the implementation of Uruguay Round results through a newly established development division and strengthened technical co-operation and training division.

(7) WTO will be a forum where countries continuously negotiate exchange of trade barriers all over the world. And the WTO already has a substantial agenda for further negotiations in many areas.

It can be expected that the WTO is different from and an improvement upon GATT, on the ground that firstly, the WTO will be more global in its membership than the GATT. Its perspective membership is already around 150 countries and territories, with many others considering accession. Secondly, the WTO has a far wider scope than its predecessor, bringing into the multi-lateral trading system for the first time, commercial activities like trade in services, the exchange of ideas in the context of intellectual property protection and investment.

2.7.4 Impact of WTO on Various Aspects of Indian Economy

India, being a founder member of the WTO, has been following the WTO decisions, but as a consequence, certain effects on the Indian economy have become evident.

WTO and Indian Industry

WTO has been urging India to lower import duties, remove controls on consumer goods imports, reduce quantitative restrictions, etc. Under the Uruguay Round Agreement, India offered to reduce tariffs on capital goods, components, intermediate goods and industrial raw materials to 40% in case our tariffs were above that percentage; to 25% in case our tariffs were between 25 to 40 per cent and to bind the tariff ceiling at 25 per cent

in case our tariffs were below that percentage. This reduction in tariffs was to be achieved by the year ending 2000.

Since India scrupulously followed the agreement, the tariffs have been reduced year after year to conform with the WTO provisions. As the protection afforded by import duties gradually disappeared, Indian industry had to face increasing competition from foreign goods. Confederation of Indian Industry (CII), the apex body expressed its disapproval against duty-free status of capital goods sector. As a result, CII estimated that indigenous capital goods industry on a conservative estimate lost orders worth Rs. 5,000 crores from foreign countries.

Not only the entire manufacturing industry is faced with a crisis, even machine tools industry, gensets and boiler producers are put at a serious disadvantage. Consequently, imports of finished products are displacing indigenously produced products. As a result, many industrial units are being closed and cheap imports have become an important cause of recession in Indian industry. India was maintaining quantitative restrictions in the form of quotas, import and export licences on 2,700 agricultural commodities, textile and industrial products. United States along with Australia, New Zealand, Switzerland, European Economic Community and Canada complained to the WTO Dispute Settlement Machinery that these QRS were inconsistent with WTO norms. The dispute settlement panel gave its verdict against India. India went in appeal, but the WTO panel on 23rd August 1999 rejected India's appeal against QRs.

As a result, although India could continue QRs till March 2003, the process was hastened and QRS on all items were removed. This has opened the floodgates for foreign consumer goods to enter the Indian market, thereby seriously damaging Indian industry.

WTO and SSI Units

WTO agreements do not discriminate on the basis of size of industries or enterprises. In the WTO regime, reservations may have to be withdrawn, preferential purchase and other support measures may not be available and thus SSIs have to compete not only with the large units within the country, but also with cheap imported products. SSIs are thus losing their markets to cheap imported products. Consequently, a very large number of SSI units are becoming sick or have closed down. Thus, the ° SSI sector which accounts for 40 per cent of manufacturing output, 50 per cent of employment and over 33 per cent of exports is in jeopardy. Next to agriculture, this sector- is the principal source of employment accommodating 18 million persons. The rule of survival of the fittest is being applied to this sector and in their game, only a few able ones will be able to survive. Dumping of Chinese goods has seriously affected SSI sector. The real difficultly with the SSI sector is that it does not have adequate resources to prepare the case for anti-dumping duties in view of the prohibitive costs of anti-dumping investigation. The SSIs cannot collect detailed information on individual products required by the anti-dumping directorate to establish a complete case. Consequently, small industries

continue to suffer due to such dumping policy.

Not only that, the entry of multinationals in ordinary consumer goods like ice cream, agarbatti manufacture, food processing, mineral water etc. is also adversely affecting the SSI sector since these were the traditional areas of this sector. In soft drinks, the entry of powerful Coca Cola and Pepsi have eliminated practically all small units engaged in the manufacture of aerated water. MNCs are not interested in hi-tech products. Rather they prefer low technology, quick profit yielding and large volume products with regular demand throughout the year. In the name of consumer interests, MNCs continue to swallow SSIs and eliminate them from the market.

WTO and Agriculture

WTO Agreement on Agriculture stipulated that developed countries would reduce their subsidies by 20 per cent in six years and developing countries by 13 per cent in 10 years. But as facts stand today, developed countries tried to circumvent this agreement by providing Green Box and Blue Box subsidies to support agriculture.

Green Box Subsidies include amounts spent on Government services such as research, disease control, infrastructure and food security. They also include payments made directly to farmers that do not stimulate production, such as certain forms of direct income support assistance to help farmers restructure agriculture, and direct payments under environmental and regular assistance programmes. This definition is very wide and includes all types of Government subsidies.

Blue Box Subsidies are certain direct payments made to farmers where the farmers are to limit production, certain government assistance programmes to encourage agriculture and rural development in developing countries, and other support on a small scale when compared with the total value of the products supported 15 per cent or less in the case of developed countries and 10 per cent or less for developing countries.

India's agricultural imports were of the order of US $ 1.86 billion in 2000-01, but they increased to $ 2.29 billion in 2001 -02. If the surge continues, then the interests of Indian farmers would be seriously affected. **Economic Survey (2002-03)** makes a forthright statement: "India has considerable flexibility to counter flooding of the Indian market by cheap agriculture imports through the imposition of tariffs (bound rates) under WTO. WTO permissible tariff rates are reasonably high: 112 per cent for nuts, 150 per cent for sugar and coffee, 100 per cent for tea and cotton, 70 to 100 per cent for foodgrains, 45 to 300 per cent for edible oils and 40 to 50 per cent for fruits. Countervailing duties can also be imposed to counter questionable subsidies given to agriculture products by the exporting countries apart from having the option of acting under safeguard provisions to counter the surge of imports. In budget 2001 -02, import duties were raised for many agri products such as tea, coffee, pulses and edible oils. In 2002-03 budget, the import duties were raised for pulses (from 5 to 10 per cent, tea and coffee (from 70 to 100 per cent), natural rubber, pepper, cardamom and clove (from 35 to 70 per cent)." (pp.

174-75) So far India has followed the Agreement on Agriculture very honestly, but honest implementation should not be treated as a sign of weakness. In case, the US and OECD countries persist in their nefarious game of protective tariffs, quotas and subsidies for their farmers, India and other developing countries may be left with no choice but to retaliate. But this would mean the start of a process which may result in the decline of globalisation world over.

However, this does not mean that at the domestic level, India has no action to take to improve its agriculture. In fact, the reform process is guilty of neglecting agriculture. In agricultural infrastructure, the most important is irrigation. The reform process emphasized the role of the private sector in promoting irrigation. But the experience of the Ninth Plan as documented in the Tenth Plan reveals that the private sector invested in irrigation technologies which were mainly extractive such as tube wells. But these investments are not sustainable unless appropriate investments are made in rain-water harvesting and recharging of ground water resources. However, data as provided by CSO reveals that in gross capital formation in agriculture, the share of the public sector declined from 33 per cent in 1994-95 to merely 23.5 per cent in 2000-01. In absolute terms, public sector investment declined from Rs. 4,947 crores in 1994-95 (measured at 1993-94 prices) to just Rs. 3,919 crores in 2000-01. Although private sector investment improved, but it did not fulfill the functions of rain water harvesting and recharging of ground water resources.

In boosting agri exports, some success has been achieved, but agri-exports which reached $ 6,004 million in 2000-01, declined to $ 5,871 million in 2001-02.

Another important area which needs attention is to make agricultural credit available at lower rates of interest. There is no doubt that the total flow of institutional credit to agriculture which was of the order of Rs. 31,956 crores in 1997-98 has more than doubled to Rs. 82,000 crores in 2002-03. This is really heartening, but the rate of interest charged on loans ranges between 14-18 per cent. This implies that the benefit of declining rates of interest has not been passed on agricultural borrowers. On account of the efforts of former Agriculture Minister Mr. Rajnath Singh, the Finance Ministry agreed to reduce interest on farm loans upto Rs. 50,000 to 9 per cent. This step, though in the right direction, is still inadequate, moreso, in view of the fact interest on housing loans has been reduced to 8.5 to 10 per cent, it is imperative on the part of the Government to bring down interest rates on all agricultural loans— short-term, medium-term and long-term. Accepting the need to reduce interest rate on agricultural loans, Former Prime Minister Atal Behari Vajpayee on 27th July 2003 announced: "Crop loans below Rs. 50,000 will be charged nine per cent interest and banks are being asked to charge the rate of interest below the PLRs for agricultural loans.

2.7.5 WTO and India's Gain as a Founder Member

In a country like India, the benefits accruing from being a founder member of World

Trade Organisation (WTO) are immense. At present, only just five per cent of our tariff lines remain bound. With the finalisation of the Uruguay Round, about 68 per cent of India's tariff lines covering basically raw materials, components and capital goods, but excluding consumer goods, petroleum, fertilisers and some non-ferrous metals would have been bound.

The Government is of the view that it is in the long term interest of India to have low duties on raw materials, components and capital goods since they satisfy the production needs of the economy.

Regarding the threat arising out of TRIPs, the Commerce Minister, Pranab Mukherjee is on record saying that exclusive marketing rights to be provided for patent holders would in no way dilute the national interest in such crucial areas as agriculture, drugs and pharmaceuticals as enough safeguards had been built into the system to.take care of the concern voiced by developing countries including India.

India now stands to gain immensely from the membership of WTO. At the time the question of this country joining the WTO was broadly under consideration, the opposition political parties strongly opposed our joining the World body. The fears expressed by the opposition parties regarding adverse effects of membership on farmers and the agricultural sector, prices of foodgrains due to withdrawal of food subsidies which would become obligatory under the terms of membership of that body and life savings drugs require us to enact have all proved almost groundless. India being a founder country has already started to assert itself in the meetings of WTO council.

Although a great deal of misinformation has been spread throughout the country on the otherwise beneficial aspects of the multi-lateral treaty, but it is to be seen how far these safeguards built into the system by the Government are sufficient enough to take care the interest of the masses as well as the country as a whole. But the ultimate impact of the Uruguay Round and the formation of WTO would depend on gains in productivity in various sectors resulting from realisation of economies of scale, technology transfer and increased trade and investment.

Moreover, India is also facing a serious threat from the attempt of the developed countries to introduce social and environmental clauses in multilateral trading system and thereby imposing countervailing duty on imports from India and other developing countries. These type of proposals have shocked the experts of the developing countries because it will deprive the developing countries of their only competitive advantage arising out of cheap and abundant labour force.

Gains for India

The Commerce and Industry Minister who represented India at the Doha WTO Conference succeeded in sending a strong message that India can no longer be ridden roughshod over by the developed countries, more especially US and the European

Union. The biggest gain was that WTO chairman declared that negotiations on Singapore issues-investment, competition, labour standards and environment would be held only after an "explicit concensus" was reached at the Fifth Ministerial. Such a concensus may not be easy to emerge even in 2003, keeping in view the reservations expressed by the developing nations at the Doha Conference.

Another major gain was that instead of opening discussion on new issues, it was agreed under pressure from India and other developing countries that it would be more advisable to undertake an exercise on a more complete implementation of Uruguay Round recommendations. This would involve review of bottlenecks and constraints arising out of the roadblocks in the way of fulfillment of their obligations by the developed countries. This would be particularly directed towards the US, Japan and countries of the European Union to open markets to products in which the developing countries enjoyed a comparative advantage.

The anti-dumping laws of the US were another painful thorn in the flesh of countries like India in respect of steel and other allied items of manufacture. This was taken up strongly by India and other member countries. The pressure built on US was so strong that the US was forced to promise a toning down of its policies and legislation pertaining to anti-dumping laws.

Growth of E-commerce and WTO Declaration

The growth in e-commerce has added a new dimension to trade policy which countries have to take account of by formulating rules to keep abreast of the fast growing technological developments. The WTO General Council agreed on the comprehensive working definition of electronic commerce as "the production, distribution, marketing, sale or delivery of goods and services by electronic means". Electronic transactions involve three stages namely searching, ordering/making payment, and delivery of products. Electronic delivery of goods is by far the most challenging aspect from a policy perspective as such trade is compounding rapidly without any global regulatory framework and hardly any national or international legislation.

In recognition of the growing importance of electronic commerce in international trade, the Second Ministerial Declaration of the WTO at Geneva adopted a declaration on global electronic commerce on May 20, 1998, which directed the WTO General Council to establish a comprehensive work programme to examine all trade related issues arising from electronic commerce. The work programme includes issues like characterisation of electronic transmission as goods or services or something else: market access involving the method of application of customs duties to electronic transmission; classification of digitized products under the existing Harmonized System (HS) of trade classification; rules of origin; standardisation; development dimensions involving the effect on revenue and fiscal positions of developing countries in future ; etc. The 1998 declaration also included a so-called moratorium stating that

"members will continue their current practice of not imposing customs tariffs on electronic transmission". The work programme was adopted by the WTO General Council on September 25, 1998.

2.7.6 Fourth WTO Ministerial Conference and the Doha Declaration and India's Role

In the fourth Ministerial Conference at Doha, India played a proactive role in the deliberations. India preferred a genuine resolution of implementation related concerns, increased market access in agriculture, sufficient flexibility and clarity under TRIPs for public health policies and strongly opposed the introduction of non-trade issues like labour in the agenda. It was able to ensure adoption of an agenda that emphasised not only trade but also the developmental goals and priorities of developing countries. It is the insistence of India that forced the WTO to amend its draft resolution at the eleventh hour even by extending the scheduled time to suit the interests of developing nations status, particularly, on the issues related to foreign investment, competition policies and environment. The conference primarily focussed its discussion on the related issues pertaining to global recession. Accordingly, the Declaration was also made— "We are determined particularly in the light of global economic slow-down, to maintain the process of reform and liberalisation of trade policies, thus ensuring that ,the system plays its full part in promoting recovery, growth and development.

As per the WTO norms, the member nations, out of its obligations, cannot discriminate against one another's goods and companies without showing any valid and justified reasons. But due to the violation of rules, most of the developing nations have failed to reap any benefits of WTO. It is a matter of happiness that in Doha, under the able leadership of India, the developing nations have been to able redress their grievances that they have fared much badly than they should have under globalisation and now the system should be changed to such an extent so that they should realise a greater share of benefits. Now the agreement so reached does not. give any immediate relief to the developing nations but the agreement ommits that the WTO members to negotiate reductions in tariff, especially on products of export interest to developing countries and the higher level of tariffs applied on goods such as textiles on which the developing countries have much better competitive strength. Moreover, under the active pressure of developing countries, the Doha Conference and its declaration also agreed to include anti-dumping on the WTO agenda.

The mandated negotiations as per Article 20 of the Agreement on Agriculture commenced in 2000. Considering its importance, India has submitted its comprehensive proposals in the areas of Domestic Support, Market Access, Export Competition and Food Security. The proposals keep in view the objectives of protecting India's food and livelihood security concerns by having freedom for taking all domestic policy measures for poverty alleviation, rural development and rural employment as

also to create opportunities for expansion of agricultural exports by securing meaningful market access in developed countries. India, with a view to garner support of other developing countries, also co-sponsored two proposals with other countries : one on market access and another on export credit for agricultural products. It is quite true that due to higher rate of export subsidies provided by EU, the agricultural prices in the developed countries have been kept at lower level deliberately thereby depriving the Third World countries to get the benefits from its agricultural exports. However, the issue was temporarily resolved by accommodating a clause in the declaration that the negotiations in this issue would be held "without prejudging" the outcome.

Under TRIPs, India has been seeking greater flexibility and clarity in the interpretation of the Agreement on TRIPs in order to ensure affordable access to essential medicines and life saving drugs, in keeping with the public health concerns of developing countries. India, the African group of countries, Barbados, Bolivia, Brazil, Dominican Republic, Philippines, Peru, Sri Lanka, Thailand and Venezuela jointly submitted a paper on TRIPs and Public Health to the TRIPs Council in which India, along with other co-sponsors had demanded that the WTO should ensure that TRIPs Agreement does not undermine the right of the WTO members to formulate their own public health policies and adopt measures for providing affordable access to medicines. Finally, the Doha declaration affirms that the TRIPs Agreement can and should be interpreted and implemented in a manner supportive of WTO members right to protect public health and, in particular, to promote access to medicines for all.

2.7.7 Conlusion

A survey of the globalisation policies followed in India reveals that the promised benefits of globalisation in the form of sharp increase in GDP, exports, foreign direct investment, reduction of poverty, deceleration of unemployment could not be realised by India during the 1990s. Globalisation has adversely affected Indian industry, it has enabled the developed countries to pusrrtheir exports to India at a much faster rate, but did not facilitate the process of access to international markets; small scale industry has suffered due to the policy of dumping practised by developed countries, more especially in consumer goods. The most distressing part of the story is the double standards practised by the developed countries which manifest in the form of unfair agreement on textiles; a policy marked by a bias in favour of the farmers of developed countries as against the poor farmers in India. Developed countries brought forth spurious environmental and social issues to prevent the exports from India of such commodities in which the country possessed comparative advantage.

2.7.8 Short answer type questions

1. Write a short note on WTO?
2. What are blue box subsidies?

3. What are green box subsidies?
4. Write a short note on Doha meeting

2.7.9 Long answer type questions

1. What is the impact of WTO and Indian economy?
2. Explain the role of WTO.

2.7.10 Recommended books

Datt and Sundaram : Indian Economy
P.K. Dhar : Indian Economy
Mishra and Puri : Indian Economy
A. N. Aggarwal : Indian Economy

Lesson No. 2.8

European Union

2.8.1 Introduction

The most prominent development in the field of economic integration has been the organisation of European Economic Community (EEC) now known as European Union (EU). Initially it was called European Common Market (ECM). It was formed on January 1, 1958 on the basis of the Treaty of Rome signed in March 1957 by the countries like W. Germany, France, Italy, Belgium, Netherlands and Luxembourg. Starting with six member countries, its membership increased to nine when the United Kingdom, Denmark and Ireland joined it in 1973. Subsequently, Greece joined it in 1981, followed by Spain and Portugal in 1986. During 1990's, the membership of EU had risen to 15 with some African, Caribbean and Pacific region countries having its associate membership. On May 1, 2004 there is enlargement of European Union (EU) with the joining of 10 new member countries. With this the membership of EU hasrisento 25. The new member countries include Czech Republic, Estonia, Hungary, Slovak Republic, Malta, Cyprus, Poland, Lithuania, Latvia and Slovania. The estimated GNP of the enlarged EU would be around Euro 9,712 billion with a population more than 455-million. The enlarged EU would represent 20 percent of the world trade, 26 per cent of foreign direct investment and 46 percent of the total outbound investments. As a matter of fact, EU would become the largest trading block in the world. The Intra-EU trade would be over twice of what it would have been in the absence of integration.

2.8.2 Objectives of lesson

In this lesson we will study about regional economic cooperation, European Union,European Economic Community, organisation, achievements of EU and its critical evaluation.

2.8.3 European Union (EU) or European Economic Community (EEC)

The EEC had been created on the basis of the Treaty of Rome which specified its objective. Article of the Treaty of Rome stipulates that "the community shall have as its task, by setting up a common market, to promote throughout the community an harmonious development by economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relation between the Member States belonging to it." So under the Treaty of Rome, the member countries of EEC are committed to:

(i) the abolition of tariff and non-tariff quantitative and other restrictions in regard to the import and export of goods between the member states ;
(ii) the abolition of all restrictions upon the free movement of persons, services and capital between the member states ;
(iii) the establishment of common customs tariff and of a common commercial policy towards the non-member countries ;
(iv) the establishment of a common farm policy ;
(v) the adoption of a common policy in the sphere of transport;
(vi) the establishment of a system ensuring that competition shall not be distorted in the common market;
(vii) the creation of a European Social Fund for improving the possibilities of employment, for the workers and for ensuring a rise in their standard of living;
(viii) the approximation of the legislations of the member states to the extent necessary for the efficient functioning of the common market.

It follows from the above that the fundamental objectives which the EEC sought to realise include the elimination of all restrictions from the free movement of goods, labour, capital and services, maintenance of common external tariffs against the non-member countries, the establishment of common policies in the spheres of transport and agriculture and closer integration in the fields of monetary and fiscal matters in the entire region. The realisation of these ends will certainly ensure a sustained expansion in trade, improvement in economic performance and a rise in standards of living for the region as a whole.

2.8.4 Organisation of EU:

The organisational structure of EU consists of the Executive Commission, the Council of Ministers, the European Parliament, the Court of Justice, the Economic and Social Committee and the Monetary Committee.

(i) *The Executive Commission:* The Executive Commission of EU is the key institution. It functions autonomously of the national governments of the member countries. The functions of this commission are related to initiation, evolution and execution of the economic policies of the community. The commission ensures the proper compliance of agreed policies by the member countries. The commission's directives are binding upon all the members. It has the authority to over-rule any such policies of the national governments as are not in conformity to the desired objectives of the EU. The commission is constituted by 14 commissioners, appointed by the member countries. The commissioners are bound on oath to work independently of the dictates of their respective national governments. The commission has a significant achievement in the field of anti-trust legislations. It brought about successful suits against multi-national corporations charged for adopting monopolistic practices within the geographical confines of the European Union.

(ii) *The Council of Ministers:* An important decision-making inter-governmental body is the Council of Ministers. It is constituted of the foreign ministers of the member countries of the EU. This body is responsible for taking major decisions related to political issues which impinge upon the economic and commercial policies. The Council of Ministers takes decisions also upon important technical matters and lays down the guidelines for political and economic policies. All issues are decided by the Council of Ministers through the majority decision. However, attempts are made to evolve, as far as possible, the consensus among the members.

(iii) *The European Parliament:* It is a consultative body constituted by 142 members representing the national parliaments of the member countries. Generally, the European Parliament holds eight sessions a year. The members of the European Union (EU) Parliament are now chosen through direct election.

(iv) *The Court of Justice:* Any dispute arising out of the different provisions of the Treaty of Rome is settled by the Court of Justice that is based in Luxembourg. This Court has the power to over-rule the decisions taken by the national courts on the matters related to EU policies and actions.

(v) *The Economic and Social Committee:* The Economic and Social Committee is constituted by the representatives of workers, employers and professional organisations of the member countries of the EU. This is essentially a consultative body.

(vj) *The Monetary Committee:* This committee is constituted by experts and central bank officials of the member countries of the EU. It performs the functions of tendering advice to the Executive Commission and the Council of Ministers on international monetary issues.

The long standing European goal of creating European economic and monetary union could be reached by the end of 1993 when all the member countries ratified the Maastricht Treaty drawn up in 1991. The European Union became fully operational from January 1, 1995. Some countries, however, retained the option not to participate in certain parts of the agreement. For instance, Britain declined to participate in the integration of social policy.

2.8.5 Achievements of EU: It is an undeniable fact that EU has emerged as the most successful integration in the post-war period. It set the common external tariff; ensured free trade in industrial goods within the European community; adopted a common price policy for farm products and; abolished restrictions on the free movement of labour and capital. From the point of view of membership, it is the largest single group of relatively more advanced industrial nations. Some of the achievements of EU are mentioned below:

(i) *Balance of trade and payments:* After the formation of this organisation, there has been a substantial rise in its exports and imports in relation to **the** rest of the world. The intra-trade of the EC as a proportion of world trade rose from 9 percent in 1960 to 14 percent in 1970. Upto 1970's the EC as a whole maintained a strong balance of payments position with the rest of the world. In 1987, the EC had surplus on balance of current account amounting to 71.1 billion dollars. In the same year, the United States was having a deficit on the balance of current account amounting to 49.4 billion dollars. In the subsequent years, the same pattern in respect of their respective balance of trade and payments has persisted and there has been an alarming widening of the deficit in the U.S. balance of trade and payments with both the EU and Japan.

(ii) *Trade-creation and Trade-diversion effects* ; A highly significant achievement of the EU has been a very substantial increase in the trade-creation. The studies conducted by Kreinin (1974) and El Agraa

(1980) showed that the trade creation due to EC was 8.4 billion dollars by 1969. In contrast, the trade diversion was only 1.1 billion dollars. The trade diversion effect due to EC became more significant in agriculture after Britain joined the EC in 1973. The EC has been overwhelmingly trade-diverting association at the expense of the U.S.A., Japan, the British Commonwealth and producers of some tropical products.

(iii) *Common agricultural policy:*The Treaty of Rome had stressed upon the evolution of common agricultural policy for all the members of the customs union. Before the formation of EC, the different countries were having their separate policies. Some of them had low support prices for the farm products, while others had a structure of relatively higher support prices. The support prices are now fixed by the council in units of account. There is a "green rate" at which the support prices are converted into the national prices. At the specified support prices, farmers are free to produce as much as they like. There is no barrier on the movement of agricultural products. In the event of internal shortage of farm products, the imports are permitted from the rest-of-the world. To restrict imports of agricultural products from non-member countries, a variable import levy is imposed. It can be raised or lowered to an extent sufficient to offset the price advantage enjoyed by the importers. If the production of farm products exceeds the requirements within the EC, the subsidies are offered to the farm producers to export their surplus produce or dispose it off within the member countries at lower prices. Thus the common agricultural policy has contributed in making the EC self-sufficient in respect of agriculture.

(iv) *Common fisheries policy:* In February 1971, a common fisheries policy was brought into operation by the EC. It is related to the marketing of fresh, frozen and preserved fish. It made provisions related to equal access to fishing areas for all EC countries, off-shore fishing facilities and common marketing standards.

(v) *Common transport policy:* The Treaty of Rome had laid down the adoption of a common transport policy by all the members of the EC. Such a uniform policy was considered desirable for ensuring unrestricted movement within the common market and general organisation and complete integration of transport system in all the member countries. In this sphere, the EC has succeeded only in removing the obstacles in transport but the complex problems related to entry controls, rate controls and infra-structural pricing are yet to be resolved for having a uniform and fully integrated transport system.

(vi) *Movement of factors:* A considerable progress has been made by the EU in ensuring free movement of workers, capital and services from one member country to the other. There is not only free movement of workers and their families, they also have equal rights to work and social security. They are subject to same taxation as is applicable to the nationals of that country.

*(vii) Integrated regional development policy:*The promotion of equitable, balanced and integrated regional development was one of the prime objectives before the EC right since its inception. For achieving balanced regional development the EC has adopted the policy of providing necessary financial assistance to relatively backward regions within the organisations. The EC orEU provides regional development assistance through such agencies as the European InvestmentB(ank. (EIB), the European Social Fund (ESF) and the European Regional Development Fund
(ERDF).

(viii) Reduction in unemployment: The expanded market, utilisation of productive capacity, adoption of latest technologies and increased investment inflow has brought about a substantial increase in industrial productivity and efficiency. As a consequence, the countries of the EU could reduce the extent of unemployment and raise the level of average earning of the people.

(ix) Common Social Policy: The member countries of EC adopted the Social Charter in 1989. It specified 12 principles related to the rights of workers and social justice. Out of them, member countries have adopted the principles of right to work and live and work at the some wages and working conditions in another state, equal opportunity legislation, regulation of maximum 48 working hours a week, protection of pension and other social security rights, health and safety regulations, creation of European Employment Service (EES) and European information network

*(x) Economic and Monetary union:*In the wake of serious monetary upheavals of 1970's, the foreign ministers of the member countries of EC agreed to establish an economic and monetary union. Following the Bremen Declaration of the Council of Ministers of the EC in 1978, the European Monetary System (EMS) was established in 1979 initially for a period of two years. The basic objective of the EMS was to maintain stability in the exchange rates of the currencies of the countries of the EC. The procedure laid down was termed as *"European Current Snake"* procedure, under which each currency in the system could fluctuate only between ± 2.5 percent against any other currency. This limit

applies in the case of the currencies of France, W. Germany, Belgium, Denmark and Ireland. The Italian Lira is allowed to fluctuate between ± 6 percent. The other members of the EC are not the members of this monetary system. The EMS has created the European Currency Unit (ECU) which is a means of settlement between the EC central banks.

The creation of single currency by the European union has highly significant *implications:*

(i) The investors will derive substantial gains in the form of lower transaction costs, increased competition transparency of prices, greater degree of certainty and stability of prices. In addition, the creation of single currency will result in uniformity of interest rate, elimination of currency risk and increased scope and liquidity to bond and equity markets.

(ii) The consumers will be benefited by the single currency through greater price transparency in the entire Euroland and possibility of greater price equalisation over the whole region.

(iii) There will be benefit for the commercial and industrial enterprises on account of ease of outsourcing, mergers and take-overs, relocation of production bases, transportation, marketing etc. There would be, undisputably, the increased global competitiveness.

(iv) The creation of single currency by the European Monetary Union (EMU) will economise, in a large measure, the cost of hedging against the exchange rate risks.

(v) The emergence of Euro is likely to have a major impact upon the dominance of US dollar in the global economy as the Euro will replace the dollar in several spheres. The share of Euro in the holding of foreign exchange reserves by central banks and governments *vis-a-vis* US dollar would increase in future. The agreement between the stock exchanges of London and Frankfurt has resulted in integrated Frankfurt-London stock exchange. With an over $ 3 billion market capitalisation, it would be the world's second largest stock exchange. There would be a strong possibility of a substantial rise in investments in the European security markets.

2.8.6 EUand the Developing Countries: A unique feature of the EC, presently the EU, is that it has remained intimately linked with the LDCs right since its inception. Some countries of Africa, Caribbean and Pacific regions have been accorded the status of 'associate members'. After the signing of the third Lome Convention in 1984, apart from 12 member countries of the EC, there are 66 associate members. The associate

members generally fall in the category of LDCs. These countries have been provided with preferential treatment in foreign trade.

As regards the other LDCs of Asia, North Africa, Gulf and South America, a link between EC and them could be established through a General System of Trade Preferences (GSP) on 1st July 1971. Under the GSP, the developing countries were permitted free entry for certain categories of their manufactured products in the markets of the EC countries. All such countries, as a matter of fact have entered into agreement of commercial and economic co-operation with the EU.

The EU has also gradually emerged as an important source of multilateral assistance for the LDCs. For meeting the demands for development assistance from the developing countries, the EC has constituted European Development Fund (EDF) and the European Investment Bank. Although it was originally conceived as an agency to finance the development projects in the economically depressed regions of the EC, yet it has increasingly financed the development projects even outside the territories of the member countries. Between 1963 and 1986, the lending operations of EIB had reached 5600 million ECU.

Since 1964, the EC has financed over 1200 projects in the less developed countries. These projects are in the fields of telecommunications, science, technology, energy and human resource development. The EC has also undertook the joint research projects in the spheres of health, environment, material sciences, energy, agriculture, food technology and biotechnology. The EC provided assistance to the developing countries in the promotion of trade, stabilisation of export earnings and the promotion of regional co-operation. In the field of rural development of the less developed countries, the projects funded by the EC include rural electrification, irrigation, primary education and community development. The assistance provided by the EC to the developing countries, except the bilateral assistance, is in the form of grants. Therefore, the EC assistance does not increase the burden of external debt upon the recipient countries.

The EC or EU assistance to the LDCs has been criticised on the following main grounds:*Firstly,* the EU assistance programme is largely confined to the territories of the associate member countries. The other countries have continued to suffer on account of excessive protectionism of the EU. *Secondly,* the GSP has not proved to be of much help to the developing countries because only 10 percent of the imports of the EU are covered by

the GSP. *Thirdly,* no doubt the EU countries have substantial bilateral assistance programme but the EU assistance programme is of a very small magnitude due to serious budgetary constraints faced by it. *Fourthly,* the EC or EU has remained outside the UNCTAD. Consequently its assistance programme for the less developed countries has remained woefully meagre.

2.8.7 Critical Appraisal

The formation of the EU has been the most significant development during the latter half of the 20th century from the point of view of the Western Europe. The EU has successfully realised the objectives for which it was created. It has brought about an expansion in the market for theproducts of member countries. It has facilitated free movement of products and factors throughout the common market. It has ensured higher rates of investment and growth for the member countries. It has led to an improvement in the balance of payments situation for the whole grouping. It has successfully overcome various international financial crises such as crisis of 'Black October' in 1987. The member countries of the EU have effectively faced the United States threats related to trade and exchange rate adjustments. They have been able to create the common currency and have made far-reaching changes in the structure of financial and stock exchange market. Still these countries have maintained cordial political relations with the countries of North America. At present, the EU has been moving ahead on the path of achieving a more enlarged and well-knit economic and monetary union.

No doubt, the EU has registered highly significant achievements but it has been criticised on several grounds mentioned below:

Firstly, the EU has certainly resulted in a large expansion in the member country trade. But it has a disturbing feature. While the trade involving new members has increased rapidly, the expansion of trade among the original members slowed in last few decade.

Secondly, the member countries of the EU have not succeeded in harmonising properly their transport, monetary and fiscal policies. That is why the rumblings of economic and monetary crises are sometimes heard in this regional grouping.

Thirdly, the formation of the EU resulted in considerable trade diversion especially in the case of farm products. The policy of high farm prices has sacrificed the interests of the consumers. The EU trade diversion has been at the expense of the countries of Latin America, Asia and Middle East apart from the U.S.A and Japan.

Fourthly, the farm policy pursued by the EU has led to huge agricultural surpluses and highstorage costs. The EU has been reducing these surpluses

through heavily subsidised exports.
The farm subsidies proved to be a major irritant in the world tradenegotiations among the United
States, the EU and developing countries at the W.T.O. Ministerial Meet at Cancun in September
2003.
Fifthly, the EU has failed in one important respect that regional economic disparities have been exacerbated. Some of the regions such as Southern Italy, the south of France and south and east of Germany have lagged behind the other regions in the matter of development.
Sixthly, the EU is presently engaged in highly complex task of transforming itself into a moreclosely integrated economic union with single currency. Apart from protracted negotiations onthis issue the member countries are required to sacrifice some of their sovereignty in economicdecision making. Some of the member countries have ratified the Maastricht Agreement but havedeclined to participate in some parts of this, agreement.
Finally, the EU has not succeeded fully in achieving a complete economic and political -union.

Inspite of certain deficiencies, it must however be admitted that the EU has largely succeeded in realising its objectives and it has made a definite positive contribution in the rapid economic advance of its member countries.

2.8.8 Short answer type questions

Write short notes on:
1. EU
2. EEC
3. Euro
4. Implications of Euro

2.8.9 Long answer type questions

1. Explain organization and achievements of EU.
2. Critically examine EU.

2.8.10 Recommended Books

1. Sodersten, Bo and Read, G.:*International Economics*
2. Salvatore, D.: *International Economics*
3. Ethier, W.J.:*Modern International Economics*

LESSON NO. : 2.9

SOUTH ASIAN ASSOCIATION OF REGIONAL COOPERATION (SAARC): Origin and growth of India's trade with SAARC

2.9.1 Introduction

The modern industrial system rests upon such techniques that can be employed economically only if the production takes place on a very large scale. This requires expanding markets on the one hand and increasing purchasing power on the other. For the fuller exploitation of the production potential of the modern techniques, certain countries having small internal geographical markets, have attempted to organise themselves into regional groupings. This is also called economic integration. The economic integration in the broadest sense means the unification of distinct economies into a single larger economy. SAARC is one such type of economic integration. This association was formed by the South Asian countries including India, Bangladesh, Pakistan, Nepal, Bhutan, Sri Lanka and Maldives in December, 1985.

2.9.2 Objectives of the lesson

In this lesson we will discuss about SAARC, its objectives, organisation, achievements and problems.

2.9.3 Objectives and Principles of SAARC

The SAARC has placed before it the basic goal of rapid economic and social

development of the countries of the region through the optimum utilisation of the collective material and human resources.

Objectives: The objectives of the Association, as specified in the Article I of the Charter of the SAARC are as under:

(1) Promotion of the welfare of the people of South Asia and improvement in the quality of their life.

(2) Acceleration of economic growth, social progress and cultural development in the region and provision for all individuals the opportunity to live in dignity and to realise their full potentials.

(3) Promotion and strengthening of collective self-reliance among the countries of South Asia.

(4) Making of contribution to mutual trust, understanding and appreciation of each other's problems.

(5) Promotion of active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields.

(6) Strengthening of co-operation with other developing countries.

(7) Strengthening of co-operation among themselves in international forums on the matters of common interest

(8) Promotion of co-operation with intranational and regional organisations with similar aims and purposes.

Principles: The Article II of the SAARC Charter has spelled out the following principles:-

(i) Co-operation within the framework of Association shall be based upon the respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in the internal affairs of other states and mutual benefit.

(ii) The co-operation among the members of the Association shall not be substitute for bilateral and multilateral co-operation but shall be complementary to them.

(iii) The co-operation among the member nations shall not be inconsistent with bilateral and multilateral obligations.

2.9.4 Organisation of SAARC

The organisation of SAARC is comprised of the Summit, SAARC Secretariat, Council of Ministers, Standing Committee, Programming Committee and Technical Committees.

The summit is the highest policy making authority of the Association constituted by the heads of all the member countries. The summit called as the council meets almost every year in member countries on a rotational basis. If even one of the head of member state can not attend the meeting, it is not possible to hold the meeting of the council.

The SAARC Secretariat, co-ordinates and monitors the execution of the activities of SAARC, services the meetings and serves as the channel of communication between SAARC and other international organisations. It was set up at Kathmandu (Nepal) on January 16, 1987. The, SAARC secretariat is headed by the Secretary-General, who is appointed by the Council of Ministers upon nomination by a member state on the principle of rotation in the alphabetical order for a fixed period of 3 years. Apart from the Secretary General, the secretariat includes also seven Directors, one from each state and the general services staff : The directors are appointed by the Secretary General upon nomination by member states for a period of three years. The term of the directors can be extended, in special circumstances by another three years by The Secretary General, in consultation with the concerned member states.

Nepal bore the initial cost of the establishment of the Secretariat. The recurring expenditures on SAARC are shared among the member countries. India contributes 32 percent of the total expenditure followed by Pakistan that contributes 25 percent of it. Bangladesh, Nepal and Sri Lanka each accounts for 11 percent and Bhutan and Maldives each accounts for 5 percent of it.

There is also the Council of Ministers which is constituted by the Foreign Ministers of all the member states of SAARC. The council of ministers is entrusted with the responsibilities to formulate policies, to review progress, to decide on further areas of co-operation, to establish additional mechanisms as deemed necessary and to decide on other matters of general interest of the Association. The meeting of the Council of Ministers in held twice a year. It may have an extra-ordinary session, if all the members states agree to do so.

The SAARC organisation, in addition, includes a Standing Committee, a Programme Committee and Technical Committees. The Standing Committee is constituted by the foreign secretaries of the member states. Its responsibilities are to monitor and co-ordinate programmes, to work out modalities of their financing, to determine intersectoral priorities, and to mobilise regional and external co-operation. This committee normally meets twice a year and submits its report to the Council of Ministers. The standing committee can institute action committees for the implementation of projects, comprised of more than two member countries. All the member countries may not have the representation on it.

In order to assist the standing committee, there is a Programme Committee comprised of senior officials. It is an adhoc body and meets prior to the sessions of the standing committee. It is entrusted with the tasks of the scrutiny of budget of the secretariat, to finalise the annual schedule of its activities, to deliberate upon any other matters assigned by the standing committee, to consider the reports of the technical committees and SAARC Regional Centres and to submit its comments to the standing committee. There are at present 12 Technical Committees

related to agriculture, rural development, environment, health, population activities, transport, communications, science and technology, tourism etc. These committees include the representatives of all member states. They prepare programmes and projects in their respective areas. They monitor and execute the activities in their fields and submit reports to the standing committee through the Programming Committee. There is rotation of chairmanship of every technical committee among the member countries in the alphabetical order every two years.

Self check exercise

Q1. What are the main objectives of SAARC?

Q2. Explain the organisation of SAARC.

Q3. Discuss the important features of SAARC.

2.9.5 South Asian Preferential Trading Arrangement (SAPTA)

At the Eighth Summit of SAARC held in New Delhi in May 1995, the member countries unanimously endorsed an agreement known as South Asian Preferential Trading Arrangement (SAPTA). The ministerial committee recommended that member countries should complete the process of ratification of SAPTA by November 8, 1995. India ratified it on September 22, 1995. After its ratification by all the member countries, SAPTA became operational on December 7, 1995, the tenth anniversary of the formation of SAARC.

Features of SAPTA: The main features of SAPTA are as follows:

(i) **Objectives:** The main objectives of SAPTA include the promotion of sustenance of intra-regional trade and economic co-operation among the SAARC nation through the extension of tariff and other concessions.

(ii) **Basic Principles:** The basic principles of the arrangement are enshrined in the Article 3 of the Agreement. According to this Article, all member states of SAARC will secure benefits equitably on the basis of reciprocity and mutuality of advantages. In this regard, the respective levels of economic and industrial development, pattern of their external trade, tariff and trade policies and system will, however, be taken into consideration. The negotiations related to SAPTA shall be carried forward step of step, improved and extended gradually in successive stages. There will be a periodical review of the agreement. The special needs of the least developed member countries will be taken into consideration and accordingly preferential treatment will be given to them.

(iii) **Scope:** The member countries will provide mutual concessions on all products, raw materials, semi-processed and processed and manufactures. There shall be trade liberalisation by preferential arrangements concerning tariffs, para-tariffs and direct trade measures. The trade negotiations of different types for the liberalisation of trade on preferential terms will be

undertaken on product by product basis, across the board tariff reductions, sectoral basis of preferences, direct trade measures.

(iv) Special Preferential Treatment for the Least Developed States: SAPTA provides, apart from other provisions, for certain special preferential treatment for, the least developed members of the Association. These include:

(a) By assisting them to enlarge their export potential through technical assistance, setting up of industrial and agricultural projects linked to co-operative financing and buy-back arrangements.

(b) By establishing the manufacturing and other facilities in the least developed member states for meeting their intra-regional demand under co-operative arrangements.

(c) By the formulation of export-promotion policies, creation of training facilities in die fields of trade and extending support to export marketing through export credit insurance, access to market information etc.

(d) By the removal of non-tariff and para-tariff barriers and the provision of duty free access, exclusive tariff preferences or deeper tariff preferences for export products.

(e) By the negotiation of long term contracts for the achievement of reasonable levels of sustainable exports.

(f) By extending special consideration of exports in the application of safeguard measures from the least developed member countries.

(g) By the adoption of greater flexibility towards the introduction and continuance of trade restrictions under critical circumstances by the least developed member nations.

(v) Balance of Payments and Safeguards: The arrangement permits any member country, faced with serious economic problems including balance of payments difficulties, to suspend provisionally the concessions allowed to import goods. In this regard, SAPTA allows the member countries some safeguard measures. First, if a product, imported from another member country on concessional terms in such a manner or in such quantities, that causes serious injury to importing member country, then the latter may suspend provisionally that concession. Second, to enable a member country to adopt balance of payments and safeguard measures, the SAPTA Agreement stipulates the provisions for information, consultation and dispute settlement.

(vi) Unconditional Extension of Negotiated Concessions: Except the concessions permitted to the least developed countries, all other concessions agreed upon under SAPTA, shall be extended to all the member nations unconditionally.

(vii) Committee of Participants: SAPTA makes provision for a committee of

participants including representatives from the member countries. The committee ensures that the benefits of trade expansion arising from SAPTA agreement accrue equitably to all the member countries. The meeting of the committee takes place once a year for the review of the progress in the implementation of the Agreement.

(viii) Non-application of the Agreement: In case the preferences have already been granted or are to be granted by one state to some other member states, and to third countries through bilateral plurilateral and multilateral trade agreements and similar arrangements, the previsions of this Agreement shall not apply to the member states.

(ix) Modification and Withdrawal of Concessions: Any member country that has extended concessions, may notify the Committee on Economic Co-operation (CEC) of its intention to modify or withdraw the concession after a period of three years. For this, the given country will enter into consultations and negotiations with another concerned country, and if necessary, negotiate for appropriate compensation. In case the agreement is reached within six months, the affected member state may be asked by the CEC to modify or withdraw the concessions. But in the event of a country leaving SAPTA, the other member shall be free to withdraw all the concessions extended to it.

(x) Withdrawal from SAPTA: Any member country of the SAARC may withdraw from SAPTA by giving six month's prior notice to the SAARC secretariat and also informing other member states.

Self check exercise

Q4. What is full form of SAPTA?

Q5. Discuss the main features of SAPTA.

2.9.6 Indo-SAARC Trade Relations

The SAARC, despite several attempts to encourage regional trade under the regulation of SAARC and the SAPTA, has not taken an effective shape as a regional trade body because of political problems between Pakistan and India hampering regional interests. Despite official declarations to transform the SAPTA into an FTA in this region by 2001, the idea seems unrealistic. India has had problems with FTAs for its neighbours do not want free trade with a giant neighbour they do not trust or like. Hence, multilateralism will remain India's only choice. During the 10 years before SAARC (1975-1985), India's exports increased from US$ 160 million in 1975 to US $ 315 million in 1984 registering a compound growth rate of 7.8 percent. During the 10 years after SAARC inception, India's exports increased from US $ 277 million in 1986 to US $ 1532 million in 1995, i.e. from eight percent to 30 percent constituting an additional growth of 22 percent. So, the SAARC has encouraged India's exports

to its member countries. Since 1991, liberalization too has increased India's exports to SAARC countries. From US $ 622 million in 1991, the exports have touched a peak level of US $ 2005 million in the year 2000, upping the decadal growth from five percent during the 1980-90 liberalisation to nine percent. Similarly, India's exports to the world during the pre- and post- liberalisation periods have witnessed an upward trend. On the other hand, India's import from the SAARC countries is quite low. It was just US $ 56 million in 1975 and rose to only US $ 105 million in 1984 and further to only US $ 182 in 1995. The immediate reform period has shown a decline in India's imports from the SAARC registering a low level of US $ 96 in the year 1993 and later picking up only to US $ 363 million in 2000. They have grown at a constant rate of 7 percent before and after liberalisation. This shows that India is not a good importer for its neighbouring countries. While the turnover of India's trade with SAARC members was US $ 382 million in 1985, it increased to US $ 1714 million in 1995 and further to US $2368 million in 2000. So, the increase in India's trade with SAARC members outclasses the rise in its trade globally, from US $ 24594 million in 1985 to only US $ 94018 million in 2000.

Before liberalization India exported mostly to Pakistan followed by Bangladesh and Maldives. But after the liberalization Nepal and Maldives became the major export destinations. The growth rate of exports to Pakistan had fallen considerably until the substantial boost of 2005. The tremendous decline in the previous years may be attributed to the tensions between the two nations. But the growth in India's export to the entire bloc has increased from 8.61 percent before liberalization to 12.43 percent after, showing an increase of 3.82 percent. The growth rate of India's imports from all the SAARC nations has been negative before and after liberalisation. Nepal is a major exporter of Indian products with a high growth rate of about 27.5 percent followed by Sri Lanka (15.4 percent) and Bangladesh (14.7 percent). Though the volume of trade with the bloc has increased, India does not have a good trading partner within the bloc. Except Nepal, all other nations have registered a very low growth rate. Overall, the growth of India's exports and imports show a growing trade imbalance between India and its neighbouring South Asian countries.

Steps towards formal economic cooperation were made with the signing of the SAPTA in 1993. SAPTA did not achieve much in increasing intra-regional trade either. Intra-SAARC trade, as a percentage of South Asia's world trade, increased from 2.42 percent ($1.59billion) in 1990 to 4.56 percent ($6.53 billion) in 2001 and marginally to 4.7 percent by 2003, mostly attributed to rapid liberalisation under bilateral trade agreements and WTO regimes, rather than to SAPTA. The SAPTA failure is also reflected in the skewed pattern of trade in the region. Since India has not fully integrated into South Asia, this purely regional agreement did not expand trade much and failed to address high transport and transaction costs. The idea of a SAFTA was mooted in

2002, and culminated into an agreement in January 2004. The SAFTA agreement is expected to come into force from January 1, 2006 on completion of all formalities. (New date is now July1). SAFTA lists additional measures not included in the SAPTA such as harmonization of standards, reciprocal recognition of tests and accreditation of testing laboratories, simplification and harmonization of customs clearance, import licensing, registration and banking procedures; removal of barriers to intra-SAARC investment etc.

An expansion of intra-regional trade by 1.6 times the current level as proposed by SAFTA is not possible in the absence of concomitant moves towards investment and trade liberalization. If this arrangement is to be successful, the political tensions will have to be kept at bay and India's role as a leader would have to be enhanced, as Roy (2004) points out that India needs to take the lead in greater regional integration since it accounts for 80 percent of the total South Asia GDP.

BIMSTEC (Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Co-operation)

This agreement includes Bangladesh, India, Sri Lanka, Thailand, Myanmar, Bhutan and Thailand. The idea of this regional cooperation was first mooted by Bangladesh, India, Sri Lanka and Thailand at a meeting in Bangkok in June 1997. The aim, purpose and principles are contained in Bangkok Declaration of June 6, 1997 on the establishment of the Bangladesh-India-Sri Lanka-Thailand Economic Cooperation (BISTEC).

At a special ministerial meeting convened in Bangkok on 22 December 1997 the Union of Myanmar was admitted to the grouping renaming it as BIMST-EC (Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Co-operation). This is known as Declaration of 22 December 1997. A ministerial meeting in February 2004 welcomed Bhutan and Nepal as new members.

The inter-regional grouping will serve as a bridge between the five SAARC countries and two ASEAN countries. BIMSTEC will have a greater potential to increase the trade among member countries by taking advantage of their geographical location in the region of the Bay of Bengal and the eastern coast of the Indian Ocean. Discussions have already been held on building a Trans-Asia Highway linking the five countries and also setting up a BIMSTEC Airline connecting the capitals and important cities of the member countries.

Held in Bangkok on 7 August 1998, the first BIMSTEC economic and trade ministers' meeting termed as the Retreat, decided that BIMST-EC would initially begin cooperation efforts in six areas. It was agreed that each country would play a lead role in planning and implementing programmes in each of the areas. The sectors and lead countries at the inception were:

Trade & Investment Bangladesh
Technology India

Transportation and Communication Thailand
Energy Myanmar
Tourism Sri Lanka
Fisheries Sri Lanka

Recognising that sub-regional cooperation can progress only in inter-governmental cooperation and coordination, and that the private sector is an engine of growth for enhancing interaction between government bodies and the private sector representatives of the five BIMST-EC countries, the BIMST-EC Economic Forum was conceptualized at a meeting in Dhaka in 1999. The BIMST-EC Economic Forum is a representative group of both the public and private sectors, formed to discuss ways for achieving the objectives of BIMST-EC and making recommendations for the ministerial meetings each year.

BIMSTEC covers a population of approximately 1.3 billion and the trade value between Thailand and other countries in the group exceeded US$3 billion in 2003. The forum is unique as the only link between South Asia and Southeast Asia, bridging South Asia's Look East policy with Thailand's Look West policy. BIMSTEC can also be considered as a mechanism to promote opportunities for trade, investment and tourism between Thailand and South Asia.

BIMSTEC's objectives stretch from creation of economic and social prosperity based on equality, to enhancement of mutual benefits in economic, social and technological aspects. They also involve intra-regional assistance in training, research and development as well as beneficial cooperation in agriculture, industry, expansion of trade and investment, improvement in communication and transport, for improving living standards and cooperation with other international organisations. India's trade with the BIMSTEC countries rose by eight percent in dollar terms and six percent in rupee terms to reach more than $6.6 billion during 2004-05, according to the findings of the PHD Chambers of Commerce and Industry.

Reflecting good performance of India's "New Age Sector", drugs and pharmaceuticals, there has been appreciable increase in the country's exports of such products to the BIMSTEC countries. The growing thaw in Indo-Myanmar relations has increased pharma exports to Myanmar by over 36 percent. Export of pharmaceutical products to Bangladesh that stood at $50 million registered a 19 percent growth. While India's exports to these countries have grown faster, imports have remained almost stagnant. Having proved its information technology worth to the world with aggregate software and services exports of over $ 22 billion, Indian software industry is making steady inroads into the BIMSTEC countries. Though starting from a very low base, Indian software exports to Sri-Lanka stood at $1.2 million. Similar trends have also been observed for Bangladesh, Thailand, and Nepal.

Member countries should work towards greater air transport liberalization, short-sea shipping, and trilateral highway linkages among India, Myanmar and

Thailand and between Bangladesh, Myanmar and Thailand, including linkages with other BIMSTEC countries. Implementation of transport linkages and physical connectivity among the member countries would generate huge benefits and expedite the trading process.

2.9.7 Appraisal of the SAARC:

SAARC is the trade organisation which is being structured by some very poor countries of the world primarily directed to accelerate the economic and social development of the South Asia. Four of the member countries of SAARC-Bangladesh, Bhutan, Maldives and Nepal are included in the least developed countries. Bhutan and Nepal are land-locked countries. They can have access to the world market through the ports of India and Bangladesh. The aggregate of exports of India to other SAARC countries were of the volume of Rs. 6100.98 crore, while its imports from these countries were of the magnitude of Rs. 1409.22 crore in 1999. The intra-regional trade of these countries is only 3.4 percent of the total trade of SAARC nations. It is clear that there is much potential for expanding the intra-regional trade among these countries.

According to Centre for Global Trade Development (CGTD) Report, the South Asian Preferential Trading Arrangement will give access to a consumer base of over 425 million people in the middle class bracket and permit the accelerated expansion of the growing points of the economies of all the countries in the region. With imports of India as 8 percent of her GDP, 34 percent in Sri Lanka and 17 percent in Pakistan, Bangladesh and Nepal, the intra-regional trade-creation and trade-diversion effects will certainly unfold great prospects for the development of the entire region. It is expected that the combined average growth rate of 7 percent per annum would be realised.

2.9.8 Achievements of SAARC

Although SAARC has remained besieged with serious political problems since its inceptions yet it could register some achievements that are as under:

(i) **Removal of trade restrictions:** The member countries have undertaken some steps in the direction of reducing quantitative restrictions on imports from one another and granted some measure of concessions on trade. From August 1998, India removed quantitative restrictions' off about 2300 items of import from member countries. Upto August, 2003, India had permitted concessions to Pakistan on about 370 items. Pakistan, by that time, had allowed concessions on import of about 340 items to India. The free-trade agreements have been negotiated by India with Bhutan, Nepal and Sri Lanka.

(ii) **Institution of Technical Committees :** In order to promote co-operation among the member countries in the fields of agriculture, rural development, environment, health, communications, science and technology, transport, tourism, education and culture, the technical committees for economic co-operation have been instituted.

(iii) **Poverty-Alleviation Programme:** SAARC has adopted the strategy of social mobilisation, decentralised agricultural development, small labour-intensive industries and human development. The priority has been given to the right to work and extension of primary education for the poor. SAARC has created a three-tier mechanism for exchange of information among member countries on poverty alleviation programme. In this connection, it has received co-operation from IBRD, UNDP and ESCAP.

(iv) **SAARC Funds:** In order to render financial assistance to the member countries, SAARC has instituted two funds-South Asian Development Fund (SADF) and SAARC, Japan Special Fund (SJSF). The SADF has three windows-window for identification of development project, window for institutional and human resource development and window for social and infrastructural development

(v) **SAARC Food Security:** The SAARC has set up die SAARC Food Security Board for making a periodic review of the food situation in the region. A reserve of 2.42 lakh tonnes of foodgrains has been created to tide over any emergency in the member states.

(vi) **SAARC Chamber of Commerce and Industry:** A SAARC Chamber of Commerce and Industry (SCCI) has been instituted with its headquarters in Karachi It has the aim to promote trade and interaction of chambers of commerce and industry of seven member countries, to organise trade fairs and to negotiate with other trade organisations for the expansion of intra-regional trade. The SCCI has played an important role in the formation of SAPTA and promoting economic and trade co-operation in the region.

(vii) **SAARC Agricultural Information Centre (SAIC) :** It was established in 1998 and acts as a central information institution on agriculture-related activities like forestry, fishery, rice, potato, live-stock etc. It assists in the exchange of information among the seven member countries also about R & D activities. The information about research and experiments related to agriculture is published by SAIC and distributed among the member nations.

(viii) **Agreements with International Organisations:** For facilitating the social and economic development of SAARC countries, the memorandum of understanding have been signed with various international organisations including UNCTAD, UNDP, UNDCP, ESCAP, ITU and Asia Pacific Telecommunity (APT) etc.

(ix) **Formation of South Asian Growth Quadrangle (SAGQ) :** In early 2000, India, Bhutan, Nepal and Bangladesh formed the South Asian Growth Quadrangle with the aim of the development of Nepal, Bhutan, Bangladesh and Eastern India and the basin of the rivers Ganga, Meghna and Brahmaputra. The countries of this area will co-operate in the fields of

multi-nodal transport and telecommunications, effective use of tourism, protection from environmental hazards and increase in trade and investments.

(x) **Bilateral Free Trade Agreements:** In order to move towards the creation of South Asian Free Trade Area (SAFTA), some of the countries of the region have forged the bilateral free trade area agreements. A major development in this regard has been the signing of the agreement between India and Sri Lanka on December 28,1998. Under this agreement, India shall permit the import of 1000 items on zero duty from Sri Lanka and the latter shall permit the duty free import of 900 items. Similar agreements have also been forged by India also with Bhutan and Nepal.

Self check exercise

Q6. Make a critical appraisal of SAARC.

Q7. What are the achievements of SAARC?

2.9.9 Problems: Although SAARC has attempted to move forward over the years, yet it has been faced with very serious problems and so far it has not been able to play its assigned role. These problems are as under

(i) **Political, ethnic and religions disputes:** The major barrier to the co-operation among the member countries of SAARC has been long-drawn political, ethnic and religions disputes among the member countries. Pakistan has been insisting over the years that co-operation in trade and other matters of social and economic development can not be possible unless India hands over its state of Jammu & Kashmir to it.

(ii) **Lack of complementarity:** The member countries of SAARC mostly produce same type of products. The successful integration requires dissimilarity in production rather than similarity. Lack of complementarity in the economies of these countries is having restrictive effect upon the co-operation among them.

(iii) **Preference to trade with hard currency areas:** Some of the member countries of SAARC prefer to enlarge their exports to hard currency areas. As a result, the promotion of intra-regional trade among the SAARC countries has remained generally neglected. .

(iv) **Deficit in Balance of payments:** The countries of SAARC including India are faced with the problem of persistent BOP deficit and consequent shortage of foreign exchange. They generally have an inclination to restrict imports and impose tariff and other restrictions rather then abolishing them.

(v) **Competition among themselves:** There is competition among some of the member countries in the export of certain products in the international market. For instance, India and Sri Lanka compete in respect of tea. India and Pakistan do so in respect of textiles and clothing. There is competition

between India and Bangladesh in respect of Jute. Such a state of affairs tends to discourage co-operation among them.

(vi) **Infra-structural inadequacies:** There is a lack of proper development of transport, communications, institutional arrangements as well as payment and clearing arrangements in the region. That is a major impediment in the expansion of intra-regional trade among the member countries.

(vii) **Big brother complex:** In view of large geographical area and natural, financial, technical and manpower resources, the countries like Pakistan and Bangladesh look at India as big brother who will over-swamp their markets with her products. India is conscious of such complex among the member countries of SAARC and has been constrained from extending fuller co-operation in the economic and social development of other countries of the region.

(viii) **Low intra-regional investment:** The member countries of SAARC look to the West and international lending agencies for capital resources and are afraid of seeking investments from India due to irrational reasons. The intra-regional investment is only one percent of total investment in the region. In contrast, 43 percent of ASEAN investment and 64 percent of EU investment is intra-regional. The increase in intra-regional investment by the investors of the member countries will certainly enhance greater co-operation among member countries of SAARC in the diverse areas.

(ix) **Bilateral preferential arrangements:** Some member countries of SAARC have entered into bilateral agreements with one another for extending trade concessions. In some cases, these concessions are even more than those assured under SAPTA. Consequently, there is no added attraction for member countries to await indefinitely the outcome of SAPTA.

(x) **Product by Product Approach:** The lack of progress in SAARC negotiations so far has been on account of the product by product approach of the member countries in the matter of granting trade concessions. Some of the products included in the lists for trade concessions are actually not traded among the member countries. The move towards the creation of South Asian Free Trade Area (SAFTA) can make headway only if the countries adopt a more wide sector-based rather than product-based approach in the extension of trade concessions.

(xi) **Transport problems:** Even though there is technical committee on transport, created by the member countries, yet the transport facilities are still less developed. The transit duties are also quite high. It is a major impediment in the creation of SAFTA.

(xii) **Trade barriers:** Despite the protracted trade negotiations among the member

countries, there are still high tariffs on several commodities. Pakistan and Bangladesh impose VAT on all imported goods. All the member countries continue to levy non-tariff barriers such as quantitative restrictions, restrictive licenses etc. Pakistan has not yet granted Most Favoured Nation (MFN) status to India, despite the fact that it is obligatory to do so under the WTO Agreement by the year 2005. Unless the countries become willing to dismantle the trade barriers, the avowed goal of creating SAFTA will remain a mirage.

Self check exercise

Q8. What are the problems in growth of SAARC?

Q9. What are the problems in the economic integration of the LDC's?

2.9.10 Summary

In this lesson we have discussed the SOUTH ASIAN ASSOCIATION OF REGIONAL COOPERATION (SAARC) , its objectives and principles, organisation of SAARC. It is a sort of economic integration for the fullest exploitation of the production potential of the modern techniques. South Asian countries have tried to organise themselves into regional grouping. These countries are India, Bangladesh, Pakistan, Nepal, Bhutan, Sri Lanka and Maldives and they have formed this association in December, 1985. No doubt, that with this type of integration market is always expanded and countries can make full utilisation of resources but some problems are always faced by the concerned countries.

2.9.11 Glossary

Bilateral	:	Two-sided - when trade is going on in two countries
Free trade area	:	when there is no restriction in trade.
Self reliant	:	self -sufficiency.
Negotiation	:	arbitration

2.9.12 Short answer type questions

Q1. What is full form of SAARC?

Q2. Why there is a need of economic integration?

Q3. What are the objectives of SAARC?

Q4. Write a note on organisation of SAARC.

Q5. Discuss the problems of SAARC.

2.9.13 Long answer type questions

Q1. Discuss the main features of SAPTA.

Q2. What are the achievements of SAARC?

Q3. Critically evaluate the SAARC.

2.9.14 Suggested Readings

International Economics : B. Sodersten

International Economics : Sadama Singh and Vaish

International Economics : D. Salvatore