

Adam Smith Institute  
Omega Report

# TRADE POLICY



*Adam Smith Institute*

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Thanks are owed to all of those who participated in this venture. For this report in particular, thanks are due to Martin Wolf, the principal draftsman of the report, Dr Brian Hindley, Andrew Hutchinson, Michael Ivens, and Deepak Lal, amongst others. Martin Wolf is Director of Studies at the Trade Policy Research Centre; Brian Hindley is Senior Lecturer in Economics at the



## FOREWORD

The Adam Smith Institute's OMEGA PROJECT was conceived to fill a significant gap in the field of policy research. Administrations entering office in democratic societies are often aware of the problems which they face, but lack a developed programme of policy options. The process by which policy innovations are brought forward and examined is often wasteful of time, and uncondusive to creative thought.

The OMEGA PROJECT was designed to develop new policy initiatives, to research these new ideas, and to bring them forward for public discussion in ways which overcame the conventional difficulties.

Twenty working parties were established more than one year ago to cover each major area of government concern. Each of these groups was structured so as to include those with high academic qualification, those with business experience, those trained in economics, those with expert knowledge of policy analysis and those with knowledge of parliamentary or legislative procedures. The project as a whole has thus involved the work of more than one hundred specialists for over a year.

Each working party had secretarial and research assistance made available to it, and each began its work with a detailed report on the area of its concern, showing the extent of government power, the statutory duties and the instruments which fell within its remit. Each group has explored in a systematic way the opportunities for developing choice and enterprise within the area of its concern.

The reports of these working parties, containing, as they do, several hundred new policy options, constitute the OMEGA FILE. All of them are to be made available for public discussion. The OMEGA PROJECT represents the most complete review of the activity of government ever undertaken in Britain. It presents the most comprehensive range of policy initiatives which has ever been researched under one programme.

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London School of Economics; Andrew Hutchinson is Principal Research Executive at the Institute of Directors; Michael Ivens is Director of Aims of Industry; and Deepak Lal is Reader in Political Economy at University College, University of London.

Trade and Industry; but even if it has disappeared, its main function has not. Although the connection is rarely made, international trade conditions are the principal determinant of the intensity of competition in the market place, and international trade policy is competition policy over international frontiers. Thus the new Department of Trade and Industry, which has responsibility for trade policy as well as for domestic competition policy, could well have been called the 'Department of Competition', such a change of name suggests itself strongly when the proper role for the ministry is understood.

The promotion (or suppression) of competition are permanent concerns of government, and it is with the exercise of this function rather than, with the details of any specific department's operations, that the present discussion is largely concerned. The direct expenditures of the Department of Trade have been modest, but the indirect effects on the efficiency of resource use in the economy as a whole are enormous. Proper reform must, therefore, follow only from a clear understanding of the Department's responsibilities for the economy.

#### IMPORTANCE OF COMPETITION

What should be the goal of a 'Department of Competition'? Should it promote vigorous competition, foster cartels, or mix the two approaches by considering each case 'on its merits'? The Department of Trade's policy has been the last. It is in favour of competition and liberal trade in general, but not necessarily in any particular case.

#### Problems of Interventionism

Why does competition matter? There is a macro-economic and a micro-economic answer to this question. So far as the former is concerned, it needs to be emphasized that to put disinflationary pressure on an uncompetitive and rigid economy must lead to extensive disruption. Such a policy of 'monetarism without markets' has, unfortunately, characterized Britain in the last several years. Yet, if increases in spare capacity brought about by curbs on aggregate demand do not lead to a rapid trimming of costs and prices, the programme to lower inflation will not only be costly but ultimately may fail altogether. The required adjustments in labour and product markets will occur only if they are both subject to sustained and vigorous pressure.

From the micro-economic point of view, competition is the best guarantee of both productive and allocative efficiency. Its alternative is, in practice, an 'industrial policy' in which governments are actively involved (iv) in the allocation of resources,



## 1. COMPETITION AS THE GOAL

The Department of Trade has been merged into a new Department of Trade and Industry; but even if it has disappeared, its main function has not. Although the connection is rarely made, international trade conditions are the principal determinant of the intensity of competition in the market place, and international trade policy is competition policy over international frontiers. Thus the new Department of Trade and Industry, which has responsibility for trade policy as well as for domestic competition policy, could well have been called the 'Department of Competition', such a change of name suggests itself strongly when the proper role for the ministry is understood.

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But governments have neither the knowledge nor the impartiality to determine which industries ought to be encouraged or retarded. They have no special insights which allow them to anticipate what future demand will be or what new technologies will eventually prove best to satisfy it. Whenever they make the attempt, they must start by asking the advice of industrialists. The latter may find it in their interests to relay well-established knowledge, but are unlikely to spread widely the new knowledge on which the prosperity of their enterprises depends. On the contrary, they will be tempted to ask governments for what the latter can always provide: an abatement of competitive pressure. Thus, whatever the disguise, an active industrial policy inevitably degenerates to a resort by government to its coercive powers, under pressure from industrial lobbies, in order to sustain (or increase) the profitability of outmoded knowledge and outworn capital.<sup>1</sup>

**Capture by sectional interests.** One must also not forget the pressures created by bureaucratic self-interest. Operation of an interventionist policy requires an extensive bureaucracy, whose functions and size will tend to expand in accordance with Parkinson's Law. The resulting convergence between the interests of industrialists and of bureaucrats adds impetus to the policy of selective intervention. Moreover, since assistance to one group of producers can only be given at the expense of harm to others, the momentum of intervention will grow still further as more and more producers demand help.

As policy comes increasingly to consist of a case-by-case examination of problems facing particular industries, a government inevitably loses a general perspective on the use of national resources. It finds itself captured, therefore, by the fallacies that, if a particular 'essential' industry is not protected or some high-technology export not promoted, the country will never recover, let alone prosper.

It is the growing domination of narrow sectoral concerns over general trade and competition policy that has been the principal feature (and the main problem) in these areas of policy during the last fifteen years or so. For government, this tendency creates more than economic dangers. Any government whose authority is pledged to particular interest groups will become permanently embroiled in international and domestic conflicts over what is to be produced and who gets what income.

The quotation is from Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* Edwin Cannan edition (London: University Paperbacks, Methuen, 1961) Vol. 1, book 1, chapter 10, para 11, p. 144.

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1. For a scathing criticism of industrial policy, see John Burton, *Picking Losers...? The Political Economy of Industrial Policy*, Hobart Paper No. 99 (London: The Institute of Economic Affairs, 1983).



## Avoiding the protectionist quagmire

There is an alternative way: to promote competition and thus encourage businessmen to allocate resources in the manner that seems best to them. The promotion of competition is, therefore, the principal theme of this report. It is from this perspective that currency policy is judged and it is in the light of this objective that existing institutional arrangements are assessed and found wanting.

The principal recommendation is that the concerns of particular interest groups should be subordinated to a general commercial and competitive policy that eschews detailed, selective, and discretionary intervention. This can be achieved only if governments refuse to interest themselves in the concerns of those interest groups. As Adam Smith once observed:

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices. It is impossible indeed to prevent such meetings... But although the law cannot hinder people of the same trade from sometimes assembling together, it ought to do nothing to facilitate such assemblies; much less to render them necessary.<sup>1</sup>

And (as critics of the private sector often overlook), he goes on to give a detailed list of the sort of protectionist measures that prevent competition and that in consequence do 'render such meetings necessary'.

Meetings in Economic Development Councils under the National Economic Development Council are not 'for merriment and diversion' but are made necessary by law. Who can be surprised that the commercial policy recommended by such groups tends to consist of sector-specific protection, cartellization and, in general, the cumulation of 'conspiracies against the public'?<sup>2</sup> The structure of the NEDC reinforces the unhealthy division of industry into 'sides' - employers, workers, and government - and invites interventionism. This is not a promising approach for the future. For these reasons, we believe that it would be better if it were allowed to die a natural death.

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1. The quotation is from Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations Edwin Cannan edition (London: University Paperbacks, Methuen, 1961) Vol. I, book I, chapter 10, part II, p. 144.

2. For an interesting discussion of the corporatist approach of the National Economic Development Council, see Vincent Cable, Protectionism and Industrial Decline (London: Hodder and Stoughton, for the Overseas Development Institute, 1983) pp. 222-6.



## OUTLINE OF THE REPORT POLICY

The discussion below starts, in Chapter Two, with trade policy and then proceeds to competition policy in Chapter Three. The distinction between the two is, however, difficult to draw. One reason for this is British membership of the European Community: what is competition policy to the Community is trade policy to Britain. More fundamentally, international trade policy is in any event the principal determinant of domestic competition.

What is done below is to make a bureaucratic distinction, that is, to define as competition policy what is done by those parts of the British government and of the Commission of the European Community that are concerned with this particular topic, while dealing with more general questions under trade or commercial policy. Following the discussion of trade and competition policies, recommendations for policy are made in Chapter Four.

## ESSENCE OF THE INTERNATIONAL TRADING SYSTEM

International trade creates global competition. The internationally agreed rules governing the trade policies of market economies (which will be referred to below as 'the international trading system') are above all intended to prevent governments from disrupting international competition. In a country whose government abides by the rules, producers and consumers are tied into an international market in which the terms of trade signal changing opportunities for production and consumption. Because of the global extent of the market, a degree of competitive pressure is imposed on all firms that do not enjoy the luxury of protection by prohibitive natural or man-made barriers to trade. International competition then forces the continuous reallocation of resources towards those activities in which they can be used in the most profitable manner.

The international trading system defines a market order. It has been created by market-economy countries, mainly the advanced industrial countries, whose citizens account for the bulk of international exchange transactions. The postwar incarnation of the system in the General Agreement on Tariffs and Trade (the GATT) was, indeed, a particularly important fruit of wartime collaboration between the United States and the United Kingdom.

Since there are no major strategic conflicts among the advanced market economies, all of whom are allies, economic relations among them are not merely a route to common prosperity but also the principal source of mutual conflict. Furthermore, neither international monetary nor international financial difficulties could exist without trade - since the international monetary system exists solely to make international trade and finance feasible, while international finance is simply deferred trade. Thus, international trade policy is neither just about economic efficiency for one country nor even about the health of the global market process - important though both are - but is the bedrock upon which is built the mutual relations of the advanced



## 2. CHAOS OF COMMERCIAL POLICY

Britain is a member of the European Community and a contracting party of the GATT. In different ways, these affiliations limit and determine what a British government can do. At the same time, they provide an opportunity for wider influence. In order to clarify these relations, the discussion begins with the underlying principles both of the international trading system and of the European Community and proceeds to a consideration of the ways in which the force of those principles has declined. Policies affecting Britain's trade policy and their determinants are then discussed. Thereupon, the issue of national security and trade with the East is briefly considered. Finally, the costs and consequences of policies affecting Britain's trade are evaluated.

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market economies.

### GATT and the Treaty of Rome

The GATT system was established in order to provide an international rule of law in what had, in the 1930s, been the worst sort of chaos: laissez faire for mercantilist governments. Its essential rules were:

- (a) the use of the tariff (a transparent and market-conforming mechanism) as the sole instrument of commercial policy;
- (b) binding tariff agreements, intended to provide predictability for all economic agents;
- (c) liberalization (via reciprocal tariff bargaining) in order to offer growing international specialization and a progressive integration of world markets; and
- (d) non-discrimination, in order to ensure the universal spread of the benefits of liberalization and to prevent both the bullying of the weak by the strong and the erosion of general liberalization by piecemeal discriminatory action.

While the GATT provided loopholes for protection and also has important lacunae, it ensured, so long as the underlying principles were taken to heart, not only an increasingly efficient and competitive world economy but, equally important, the compatibility of national policies as they affect the production of goods. If each government's policies were conducted at a general level and within a multilateral system, conflicts over particular industries and bilateral trade balances could be avoided. The system could ensure not only economic progress, but a substantial degree of harmony among the major trading nations, at least as far as economic relations are concerned.

Among the most significant lacunae in the GATT (and one that appears to have grown in importance over time) is that it contains very few provisions which are widely agreed to apply to services. Yet international trade in services - what are sometimes called invisibles - is beset by all of the same problems as trade in goods. To that extent the order created by the GATT was defective ab initio.

The Treaty of Rome, which established the European Community, was in its essence fully compatible with this global order; and

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1. For a discussion of the postwar international economic order and further references to literature on it, see Lord McFadzen et al., Global Strategy for Growth: a Report on North-South Issues, (London: Trade Policy Research Centre Special Report No. 1, 1981), chapter 3.



in regard to internal trade, it avoids many of the loopholes and lacunae of the GATT. Thus, the Treaty insisted upon free trade in goods and services, free competition, free movement of capital and labour, and (more remarkable still) authoritative interpretation of the Treaty by a supranational body in the shape of the European Court of Justice. Externally, the Community has played a major role in three successive rounds of GATT negotiations over the reduction of tariffs. As a binding Treaty on liberal lines, among countries that account for a very large proportion of world trade and are collectively the world's most significant trading entity, the Treaty of Rome provides potentially powerful support for the international trading system.

### Evaluating commercial policy

A country's commercial policies can be evaluated from two points of view. From a global perspective, the question is whether its policies make possible the survival of a smoothly functioning international trading system. So far as this is concerned, what can be required of a country is the liberal, predictable policies enjoined by the GATT. Such policies are especially important in the case of those large economies, like the United States or the European Community, that determine the performance of the system as a whole.

Meanwhile, from the point of view of the country itself, the question is whether its policies lead to effective competition and an efficient use of resources. Economic theory suggests that, except where the aim is to exploit monopoly power in trade (a dangerous game at best), a country should not impose barriers to trade. Other forms of intervention are preferable if there really is a need to offset distortions or imperfections in the market place. The main reason for this result is that trade policy intervention amounts to a subsidy to domestic producers combined with a tax on consumers. In consequence, whether the aim of protection is the tax or the subsidy, there will be an unwanted side-effect. Thus protection is almost always an

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1. On the essential characteristics of the Treaty of Rome, see Jan Tumlir, 'Strong and Weak Elements in the Concept of European Integration', in Fritz Machlup, Gerhard Fels, and Hubertus Mueller-Groeling (eds.), Reflections on a Troubled World Economy: Essays in Honour of Herbert Giersch (London: Macmillan, for the Trade Policy Research Centre, 1983). See also Martin Wolf, 'The European Community's Trade Policy', in Roy Jenkins (ed.), Britain and the EEC, Proceedings of Section F (Economics) of the British Association for the Advancement of Science, Liverpool, 1982 (London: Macmillan, 1983).



inefficient means of attaining any given economic goal.<sup>1</sup>

What then is the relation between the principles and rules of the international trading system and the economist's view of optimal unilateral trade policy? The answer is simple. GATT rules and principles are far more permissive than economic logic requires. (By comparison, European Community rules on internal trade are generally closer to those requirements.) Thus, a country that attempts to follow the best available trade policy should not find it necessary to take advantage of the loopholes that were built into the GATT. Furthermore, contrary to a widespread but erroneous belief, the pursuit of national interest should almost never require a violation of GATT rules. Whenever this claim is made, one finds that a sectional interest is being confused with national interest or, in other words, that the economic benefit of a group at the expense of the nation is being identified with that of the nation. The reason is obvious. Protection almost never increases a country's income but rather redistributes it and in such a way that aggregate income is reduced. It is a politically effective but economically costly way of benefitting a particular group at the expense of the rest of society.

#### EROSION OF THE INTERNATIONAL TRADING SYSTEM

Any competition is painful; and in the case of trade, competition is associated with a shift of purchases to suppliers abroad. Unfortunately, while the market may be international, governments are not, and it is to the latter that those who fail in the former usually turn. Thus any liberal international trading system is very fragile.

#### Pressures for protection

There is a long history of economic analysis to justify protection on efficiency grounds - the infant industry argument, for example - but such considerations have had little to do with protection in advanced market economies. In practice, the purpose of most protection in these countries is the maintenance

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1. The case for free trade, while allowing for other interventions, is set out in a simple manner in W M Corden, Trade Policy and Economic Welfare (Oxford: Clarendon Press, 1974). This important argument was made in Jagdish N Ghagwati and V K Ramaswami, 'Domestic Distortions, Tariffs and the Theory of Optimum Subsidy', Journal of Political Economy, Vol. 71. No. 1 (February 1963), pp. 44-50. See also James E Meade, Trade and Welfare (London: Oxford University Press, 1955), and Harry G Johnson, 'Optimal Trade Intervention in the presence of Domestic Distortions', in Robert E Baldwin et al., Trade, Growth and the Balance of Payments: Essays in Honour of Gottfried Haberler (Chicago: Rand McNally; and Amsterdam: North Holland, 1965).



of the income and the value of the capital of those involved in uncompetitive activities.

The popularity of protection can be explained in part by the fact that its true costs and consequences are easily concealed both by the nature of the device itself and by the inky cloud of xenophobic rhetoric that surrounds any discussion of its merits. Also important is the superior organization of the small group with large individual interests to defend compared to that of the citizenry as a whole.<sup>1</sup> Neither ignorance, nor xenophobia, nor more effective political organization is, however, the whole story. It has to be remembered as well that in market economies, competition is more than a means of generating wealth; it is a value. Moreover, while domestic competition is compatible with that value, international competition is often not.<sup>2</sup>

The difference between domestic and international competition is that in the case of the latter, a firm's success or failure need have nothing at all to do with its own efforts. Differences among countries in resources, institutions, and laws can be decisive. The constantly reiterated demand for 'fair not free trade' reflects a perfectly genuine feeling of injustice. It is possible to regard the slogan as no more than a demand to restrict competition to those with whom one can compete, but that would be too cynical. Understandably, affected businessmen and workers do not perceive any moral justification for being put out of work by those whose competition they are clearly unable to resist. Unfortunately, the political legitimacy of this demand runs counter to one of the main reasons for trade: to take advantage of the differences in resources and productive capabilities between countries.

Sometimes the view that trade is unfair is linked to a serious misunderstanding, namely that a country as a whole is in competition with others. It is then argued that, if wages are lower or subsidization more extensive in one country than in another, the latter will be entirely unable to compete. The analogy here - understandable but entirely false - is with competition among companies within a country. It is true that,

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1. On the argument that small groups find it easier to organize than large ones see Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups (Cambridge, Massachusetts: Harvard University Press, 1971) or Olson, The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities (New Haven and London: Yale University Press, 1982), chapter 2. An interesting survey of the political pressures of protection is in Robert E Baldwin, 'The Political Economy of Protectionism' in Jagdish N Bhagwati (ed), Import Competition and Response (Chicago and London: The University of Chicago Press, 1982).

2. This point was made in Martin Wolf, Adjustment Policies and Problems in Developed Countries, World Bank Staff Working Paper No. 349 (Washington: World Bank, 1979), p.57.



other things being equal, if a firm enjoys lower wages than its competitors, the latter will not be able to compete. In the case of trade among countries, however, other things are not equal, since a lower wage level, for example, reflects a lower average productivity of labour, with the former matching the latter. Similarly, within a country, subsidies to one activity imply taxes on others. It is impossible, therefore, for a country to be more competitive than another in everything because of subsidy policies. What trade does is to stimulate a competition for scarce resources among activities within a country, the 'winners' being those that can offer the highest rewards to the owners of scarce factors of production.

Even if the fallacious arguments were to disappear entirely, there would still remain the feeling that competitive pressures which result from fundamental differences between countries are unfair and ought to be resisted. Examples can readily be given of the consequences of these attitudes. Free trade in agricultural products is especially difficult to achieve, because the availability (and therefore the price) of land differs so much across countries. The Common Agricultural Policy, for example, is a descendant of the refusal of European countries to accommodate imports of grain from the North American prairies more than a century ago. Again, the friction of European and North American countries with Japan is largely the result of the latter's overall surplus in trade in manufactures, which in turn reflects the country's lack of natural resources. Yet another example of frictions created by ineradicable differences among countries is the resistance to imports from developing countries, whose principal resource is cheap unskilled labour.

The same powerful emotions about lack of 'fairness' come to the surface where trade among countries with similar resource endowments is concerned, whenever one country provides special favours for particular sectors or firms. Thus, there is a general unwillingness to trade freely with countries that are engaged in active programmes of industrial assistance. As such assistance has become more common, it has also become a major source of conflict among the advanced market economies.

Over time, the belief that international trade does not represent fair competition appears to have grown. There are two principal reasons. The first is that countries with very different resource endowments have become producers of goods that compete directly with production in advanced industrial countries. As development spreads, this source of pressure will grow. The second reason is the growth of industrial interventionism. These two underlying forces are increased in potency by present high unemployment and the associated resistance to structural change. The consequence of all these pressures has been growing protectionism in the advanced market-economy countries. Britain, for example, has made a particularly noteworthy shift from its traditional liberalism towards greater protectionism in the last decade.



### Symptoms of erosion<sup>1</sup>

The growing pressure on the international trading system has three principal manifestations: mercantilism, bilateralism, and sectoralism.

Mercantilism can be seen as the belief that a surplus is the goal of trade policy, that exports are the **means** towards that goal, and that imports are the **cost** of international exchange, 'the canker at the heart of trade' as Flaubert once put it.<sup>2</sup> A characteristic of present-day mercantilism has been the resources devoted to export promotion. Indeed, in some countries, ministers of trade seem to regard their job as that of international salesmen rather than policy-makers. At the same time, large funds are being expended on subsidized export credit. Particular attention has also been devoted to bilateral trade balances, especially with Japan, and also to the latter's overall current account surplus.

Bilateralism has emerged both as a symptom of concern and as an instrument of policy. One sees governments complaining that just a few inordinately competitive producers are making it impossible for them to live by their general commitment to liberal trade. At the same time, they complain about the bilateral trade deficits that are sometimes a feature of their trade with those countries. Selective protection - discrimination, in short - is then the chosen means of dealing with bilateral problems. As a result, voluntary restraint arrangements (VRAs) have become increasingly common, although they clearly violate the principles and rules of GATT.

Just as bilateralism has a close relationship to the growth of mercantilist attitudes, especially vis-a-vis Japan, so **sectoralism** is related to bilateralism. Governments have become increasingly concerned with the sectoral structure of their economies and have attempted to support particular firms and industries against the consequences of free competition. The means chosen vary, but usually include protection. The reason is that budgetary pressures, an unwillingness to make the costs of support visible, and (in some cases) ideology impose some limit on willingness to employ direct subsidies. In consequence, there have been many attempts to raise the prices paid for selected products.

For any net importable, protection on its own can be used to raise prices. For a net exportable, however, protection is needed in order to allow higher prices but is insufficient to bring them about. Public purchases in order to support prices,

1. For a discussion of the erosion, see Lydia Dunn *et al.*, *In the Kingdom of the Blind* (London: Trade Policy Research Centre Special Report No. 3, 1983), chapter 3.

2. See Gustav Flaubert, *Dictionnaires des Idées Recues*.



cartellization, and the storage or dumping of surpluses are then also employed. Meanwhile, in certain cases, protectionist public procurement policies will bring about about the desired result without resort to measures at the border.

#### **POLICIES AFFECTING BRITAIN'S TRADE**

The connection between sectoralism and bilateralism is that for a government concerned only with producer interests, the VRA is a politically effective way of raising prices. The costs to consumers are virtually invisible. Meanwhile, all producers are given something: both domestic and unrestricted foreign producers obtain protection from restricted foreign producers, while the latter - who are presumably the most competitive - gain the fruits of the cartel that they are not merely invited but **compelled** to form against the citizens of the importing country. In effect, the latter abandons to the restricted suppliers the obvious benefit of protection from the point of view of a government - namely tariff revenue and the ability to improve the country's terms of trade by restricting imports. Thus the bilateral restraint arrangement is the logical consequence of a commercial policy that identifies the national interest exclusively with that of particular producers.

#### **Erosion from without**

In addition to the pressures for erosion from within, one must not forget the assaults on the liberal international trading system from without. Developing countries have for the most part never accepted its disciplines, and as their numbers have grown, have pressed the United Nations and its specialized organizations for significant modifications. Through the Generalized System of Preferences (GSP), that was sponsored by the United Nations Conference on Trade and Development (UNCTAD), discrimination has become an integral part of the trading system. Similarly, UNCTAD has sponsored the 40:40:20 rule, which aims to restrict the shipping of third parties to twenty per cent of the commerce between any pair of countries. More fundamentally, there has been consistent pressure to replace the global market economy with a regulated and corporatist system to be managed by permanent negotiation.<sup>1</sup>

#### **Challenge to statecraft**

In brief, the maintenance of a liberal trading system is a major challenge to statecraft. For a country like Britain with an influential position in the world, what is therefore required is not merely the preservation of an efficient trade policy that leads to a competitive domestic economy: through its memberships of the European Community, the GATT, and the United Nations, Britain can help to determine whether the system that is the

Economic Service Working Paper No. 62 (London: Department of Trade and Industry, 1981)

1. For a discussion of this tendency, see Lord McFadzen et al., Global Strategy for Growth, op. cit., chapter 4.



foundation of relations among the advanced market economies will long endure.

## POLICIES AFFECTING BRITAIN'S TRADE

Within the international framework considered above, a clear view of policies governing British exports and imports can be obtained. Measures include the tariff and non-tariff barriers to imports, and policies for export promotion, each of which will be considered in turn.

### Tariffs

Britain's external tariff is that of the European Community. As such, it is generally low. After the tariff cuts agreed during the Tokyo Round of multilateral trade negotiations are completed, the European Community's weighted average tariff on industrial products will be 4.7 per cent.<sup>1</sup> While there will still be peaks and troughs sufficient to cause concern about the variability of protection and developing country complaints about tariff escalation, neither is a major issue. The low level of tariffs of the European Community and other industrial market economies reflects the successful completion of seven rounds of multilateral trade negotiations within the GATT. Meanwhile, so far as trade within Europe is concerned, Britain has no tariffs against industrial imports either from other members of the European Community or from members of the European Free Trade Area (EFTA).

### Non-tariff barriers to trade in goods<sup>2</sup>

Trade in agricultural commodities is largely regulated by the Common Agricultural Policy (CAP) of the European Community. So far as external trade is concerned, this means that the principal import barrier is the variable levy. There are also European Community subsidies for exports of surplus commodities. Meanwhile, internal trade within the European Community is far from free, since the 'green currency' system means that taxes are levied and subsidies offered at internal borders, depending on

1. See The Tokyo Round of Multilateral Trade Negotiations, Supplementary Report by the Director-General of GATT (Geneva: GATT Secretariat, 1980), Vol. II. Table 2, p. 37.

2. An excellent discussion of non-tariff barriers to imports is in D C Jones, Visible Imports Subject to Restraint, Government Economic Service Working Paper No. 62 (London: Department of Trade and Industry, 1983).



the discrepancy between actual and 'green' exchange rates.<sup>1</sup>

Britain's imports of industrial products both from other members of the European Community and from outsiders are subject to a wide range of non-tariff barriers, of which the principal ones are quantitative import restrictions, voluntary restraint arrangements, subsidization, public procurement, and technical barriers to trade. Taken together, they create an additional psychological barrier - uncertainty.<sup>2</sup>

**Restrictions.** There are a number of import restrictions in force in Britain, many of which are of long standing. They have been recognized in official Community policy, although the restrictions themselves apply only to British imports from outside the European Community. Almost all of these restrictions are against state trading countries. The exceptions to this rule are restrictions on imports of phosphate fertilizers, yarn of polyamides for carpets, polyester filament yarn, jute manufactures from Bangladesh and India, and bananas from the dollar area.<sup>3</sup> In the case of Britain, such 'residual' import restrictions are of little importance.

VRAs, by way of contrast, are one of the most innovative and significant components of trade policy. Products currently covered by such restraints include footwear (with South Korea, Taiwan, Czechoslovakia, Poland, and Romania), pottery (with Japan and Taiwan), cutlery (with Japan, South Korea, and Taiwan), music centres (with Japan, South Korea, and Taiwan), colour televisions (with Japan), portable monochrome televisions (with Japan, Singapore, South Korea, and Taiwan), monochrome televisions (with Japan) and - most important - cars (with Japan). Most of the restraints are, therefore, against Japan, East Asian newly industrializing countries or state trading countries.<sup>4</sup>

The negotiation of VRAs by members of the European Community - often surreptitiously via industry-to-industry agreement - has two purposes. Firstly, it gives governments a freedom of action in commercial policy which membership of the European Community

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1. On the CAP see, for example, T E Josling, Mark Longworthy, and Scott Pearson, Options for Farm Policy in the European Community, (London: Trade Policy Research Centre, Thames Essay No. 27, 1981).

2. For the categorization employed below and much of the information on which the analysis is based, we are indebted to Peter Holmes and Geoffrey Shepherd, 'Protection in the European Community: Internal and External Aspects', presented to the eighth annual conference of the International Economics Study Group, held in the Isle of Thorns, Sussex, 16 to 18 September 1983.

3. See Jones, op cit., Annex II, list D.

4. Ibid., Annex II, list C.



was supposed to have terminated, since a true customs union (as opposed to a free trade area) ought to have a common set of external barriers. Secondly, it provides a relatively discreet way of avoiding the non-discriminatory action stipulated in the GATT's Article XIX, which deals with emergency protection.

For the European Community as a whole, the proliferation of national restraints appears as a threat. One immediate consequence is that member countries reinforce their individual restraint arrangements by the use of Article 115 of the Treaty of Rome in order to control deflection onto their market of goods imported elsewhere in the Community. Such action, in turn, leads to a debate over the 'rules of origin' which are designed to specify what is or is not a Community product. In the process, the European Community tends to become less and less of a common market. At the same time, the very fact of individual member countries negotiating their own barriers, to trade threatens the bureaucratic interests of the Commission.<sup>1</sup>

The Commission has responded at two levels. The first, under pressure from France and Britain, has been to try to make it easier for governments and - above all - the Community as a whole to impose selective restraints more visibly by making them legal under GATT. In accordance with this goal, the Community demanded changes in Article XIX of the GATT to allow selectivity, but the attempt to negotiate common Community-wide restraint arrangements whenever the proliferation of national VRAs has appeared to be getting out of hand, failed during the Tokyo Round of multi-lateral trade talks.

Negotiation of Community-wide restraint arrangements was managed successfully in two particularly 'sensitive' sectors in 1977, when comprehensive export restraint arrangements affecting imports of steel products, textiles, and clothing from outside Europe were established under European Community auspices. In the case of steel, the restraints were bilaterally agreed with all major external suppliers and included suggested minimum prices (with the threat of anti-dumping action behind them). These restraints are intended to support the European Community's official steel cartel, which was created under authority supposedly given by the Treaty of Paris, establishing the European Coal and Steel Community.<sup>2</sup> In the case of textiles and clothing, the European Community has reached bilateral agreement on a comprehensive set of export restraints with so-called 'low cost' suppliers. The authority for these agreements is the Multi-Fibre Arrangement, a major derogation from the GATT,

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1. For a discussion of the conflicts over trade policy between member countries and Community organs, see Wolf, 'The European Community's Trade Policy', loc cit.

2. On the steel restraints, see Kent Jones, Impasse and Crisis in Steel Trade Policy (London: Trade Policy Research Centre Thames Essay No. 35, 1983).



first agreed in 1973 and renewed in 1977 and 1981.<sup>1</sup>

Textiles and steel are the only sectors in which the European Community has in force a comprehensive set of restraints covering a substantial number of suppliers and the whole Community market. The third main arena for Community-wide pressure and concern is already apparent from the list of British restraints, namely imports from Japan. Accordingly, the Commission has taken an increasingly active role in co-ordinating policy towards Japan; and this activity culminated in early 1983, when negotiations were conducted on a number of Community-wide restraint arrangements. One of the immediate stimuli to this negotiation was the decision of the French government to route all imports of videotape recorders through a small internal customs post at Poitiers. Community negotiators went to Tokyo with a long shopping list of items on which Japan was asked to show restraint. The list included videotape recorders, light commercial vehicles, forklift trucks, motorcycles, quartz watches, hi-fi equipment, cars, numerically controlled machine tools, and colour television sets and tubes - virtually everything, in fact, in which the Japanese have shown themselves to be competitive.

An agreement between the European Community and Japan was finally announced on 14 February 1983 to last for three years. (Was this a St Valentine's Day massacre or, as Americans would call it, 'a sweetheart deal'?) The Japanese promised to operate quantitative restraints on exports of videotape recorders and colour television tubes of above 52 centimetres, but only to monitor exports of the other products. In the case of videotape recorders, exports were not to exceed 4.55 million in 1983, while for television tubes the limit was 900,000. The Japanese also agreed to impose minimum prices on their exports of videotape recorders.<sup>2</sup>

**Subsidies.** Import controls and voluntary restraint arrangements are directed at suppliers outside the Community with only indirect effects on the Community itself. This is not true of industrial subsidization. In the case of Britain, much subsidization acts as a barrier to imports (or, in certain cases, a stimulant to exports).<sup>3</sup> The popularity of subsidies is itself largely explained by the fact that it is the only effective instrument for dealing with competition from within the Community.

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1. On textile and clothing restraints, see Donald B Keesing and Martin Wolf, Textile Quotas against Developing Countries (London: Trade Policy Research Centre Thames Essay No. 23, 1980).

2. See the Financial Times, London, 14 and 23 February 1983 and the Wall Street Journal, Brussels, 14 and 15 February 1983.

3. On the use of subsidization as trade policy, see Richard Blackhurst, 'The Twilight of Domestic Economic Policies', The World Economy, December 1981, pp. 357-73.



Highly subsidized sectors in Britain include the manufacture of steel and cars, shipbuilding, and coal mining among the older industries, and aero-engines, civil aircraft, and nuclear power among the newer ones. Selective subsidization of particular investments and devices like the former Temporary Employment Subsidy, much of which went to textiles and clothing, also have significant effects on trade. Because of the trade-diverting effects of subsidies, effort has been expended by the European Community on controlling national subsidization policies. In certain cases, indeed, Community-wide protection against outsiders may be seen as an alternative to national subsidization, that is, as a way of buying out a part or even all of it.

**Public procurement** has historically been biased against imports. In the case of Britain, the main international restraint on protectionist public procurement policies is the code agreed during the Tokyo Round. The European Community itself has failed to agree on significantly more liberal rules for public procurement than those in the GATT code. Apart from defence industries, it is probably manufacturers of telecommunications, power-generating, water-processing, and data-processing equipment that benefit most from protectionist public procurement policies.

An interesting example of protectionist public procurement in Britain is the government's decision to limit the Central Electricity Generating Board's imports of coal, which was put into effect in 1981.<sup>1</sup> Under this policy, the government is paying large subsidies to the CEGB to compensate for the costs of stockpiling Australian coal that has already been purchased. While procurement policies are undoubtedly highly protectionist, their effects on trade have probably not increased much in the past ten years or so, since, even though public budgets have become an increasingly important part of GNP, it is transfer payments rather than government consumption that have increased the most.

Finally, there are **technical barriers to trade**, namely regulations on quality, and testing and certification procedures. In the case of Britain, probably the most important technical barrier to trade has been the result of a failure to agree on common European Community procedures for granting 'Type Approval Certificates' for cars. As a result, only personal import of cars into Britain is permitted and manufacturers have been able to charge much higher prices for cars in Britain than elsewhere in the European Community.<sup>2</sup> It should be remembered, however, that while this particular restriction appears to be protectionist in intent, neither quality regulation nor testing and certification procedures are necessarily protectionist in

1. See The Times, London, 23 April 1983.

2. See Brian Hindley, 'Why a £9,000 Car in Britain Costs £6,000 in Belgium', The World Economy (September 1982), pp. 149-57.



themselves.

### Barriers to trade in services

With respect to trade in services, and in contrast to the positions it sometimes adopts with respect to trade in goods, Britain is relatively liberal. In some areas - for example, shipping, insurance, and banking - it is liberal without the need for the qualifier 'relatively', even though there have been unfortunate lapses such as the Monopolies and Mergers Commission Report recommending that the Hong Kong and Shanghai Banking Corporation should not be permitted to acquire the Royal Bank of Scotland. In other areas - for example civil aviation - it would not be accurate to describe the policy as liberal without qualification; but nevertheless, it is still relatively liberal. In all these areas, the British government comes up against the opposition of its European trading partners and has had far from enthusiastic support from the Commission of the European Communities. In consequence, the potentially valuable words of the Treaty of Rome have remained largely ineffective, and numerous impediments to trade in services within the European Community remain.

### Export promotion

Apart from these many devices to restrict and discourage imports, Britain is involved (like many other countries) in the active promotion of exports. Thus, the government provides commercial information, export credit insurance, and subsidization of export credit. The provision of export credit guarantees is not itself a form of subsidization, but the subsidization of export credit is. Britain was for some time a country with relatively high interest rates because of its relatively high inflation rates. Under the OECD consensus on rates of interest for export credits, however, Britain could offer the same interest rate as countries with lower domestic interest rates and make up the difference. The sums involved are large - provision for such subsidies in 1982-83, for example, having been £536 million. (New consensus arrangements should prevent any further increase in export subsidies as the consensus rate is now linked to movements in a basket of OECD interest rates.) These subsidies benefit in unknown proportions not only the exporters of construction services, plant, and equipment but also the importing countries.

### Le plus ça change...

What sense can be made of the complicated array of policies governing Britain's trade? Unfortunately, not much. One observes a general framework of liberal policies in accordance with the results of GATT negotiations and the Treaty of Rome. There also exist long-standing exceptions in the form of import restrictions and, more important, protectionist public



procurement policies. Regulation of quality also continues to be used as a protectionist device, notably in the case of cars, although there have been many other examples in Britain such as milk and turkeys. Finally, and most important, there is the growth of sectoral systems of protection in agriculture, textiles and clothing, and steel; of VRAs, which cover an increasingly large proportion of imports from Japan in particular; and of industrial subsidization. Thus the general erosion of discipline is perfectly mirrored in policies affecting Britain's trade. As water finds its own level, so has protectionism found new and strange forms when older ones have been removed by both treaty and negotiation. The intensity of feeling from the adversely affected parties clearly has an impact which is not easily offset by considerations about DETERMINANTS OF POLICIES AFFECTING BRITAIN'S TRADE.

What has created the trade policy one observes? Five elements can be distinguished: economic circumstances, the lobbies, the government, international institutions, and international relations. Large and diverse to be able to shield governments from the need to respond to every pressure-group. Furthermore, governments have objectives and programmes of their own, and face constraints which they cannot ignore. For this reason, it is never possible to consider commercial policy as

Economic conditions  
Liberalization of trade barriers occurred during the long boom that started shortly after the second world war and ended in 1973. (Whether liberalization was cause or consequence of this economic success need not detain us.) The commitment to liberal trade eroded after 1973 as rising unemployment and slow growth put increasing pressure on governments: the biggest surge in European Community protection occurred over steel and textiles in 1977, by which time the anxieties created by the 1974-75 recession and the rapid changes affecting particularly vulnerable sectors had worked their way through the political system. Account must also be taken of the increasingly visible impact of industrial imports from countries markedly different from those of Western Europe, especially Japan and the developing countries. Imports into Britain were imposed. In fact, almost all of the present VRAs, as well as the basic pattern of industrial subsidization, had been established by 1979, and much

Lobbies  
Protectionist lobbies always exist, but the pressure they exert has been increased by two developments: their past successes and a corporatist bureaucratic and political structure that invites them into the heart of the policy-making process.<sup>1</sup> Thus, each grant of protection is both a precedent and a stimulus for others. At the same time, the very existence of organizations like the National Economic Development Council, or even the

1. Cable has an interesting discussion of protectionist lobbies in textiles and clothing, footwear, cutlery, and consumer electronics. See Cable, Protectionism and Industrial Decline, op. cit., chapter 7.



Department of Trade and Industry itself as presently structured, is a standing invitation to protectionist lobbying.

### Policy-makers and the bureaucracy

Ministers do not see the world as economists do. They usually have no economic training or background, and so the efficiency aspects of free trade are not very dominant in their minds - especially when their own experience is largely pressures from those who are adversely affected by open trade. The beneficiaries are rarely represented in discussions and the intensity of feeling from the adversely affected parties clearly has an impact which is not easily offset by considerations about the (more diffused) benefits to the economy as a whole.

But while political pressure appears to be increasingly strong in one direction, government is not just a passive supplier of what lobbies demand. British political parties at least are sufficiently large and diverse to be able to shield governments from the need to respond to every pressure-group. Furthermore, governments have objectives and programmes of their own, and face international constraints which they cannot ignore. For this reason, it is never possible to consider commercial policy as solely the product of a Hobbesian war among interest groups.

In the case of Britain, governments have had a strong and abiding leaning towards liberalism since the early nineteenth century - the principal exceptions having been the 1930s and 1940s. After 1974, however, a politically weak Labour government succumbed to strong pressures from industrial protection and became a decisive voice within a European Community polarized between opposing French and German views. In this way, the British government appears to have played a major role in European Community protectionism in the second half of the 1970s and especially in 1977, which may be called 'the year of textiles and steel'. It was also in the same year that restrictions on television imports into Britain were imposed.<sup>1</sup> In fact, almost all of the present VRAs, as well as the basic pattern of industrial subsidization, had been established by 1979, and much of it between 1974 and 1979, although in certain cases - agriculture, textiles and clothing, and some nationalized industries - the policy of extensive government assistance went back much further into the past.

The Conservative government has been true to its name. It has conserved not only the incoherence of the trade policies of its predecessor but assistance to much the same sectors and the same general stance within the Community. Because of a general attachment of the ideal of free markets, however, it has been unwilling to countenance a major extension of protection to new areas, except in the case of the supplier all Europeans love to

1. Ibid. p. 209.



hate: Japan.<sup>1</sup> In the context of high unemployment, this may perhaps be regarded as an achievement; but a fair judgement of the government's policies must nonetheless be that things have been getting worse, though more slowly than before.

Furthermore, the role of the bureaucracy is also important. This became larger and more powerful during and after the war. The development of bureaucracy involved with 'industry' and 'agriculture', and the notion of playing a sponsorship role have been a major influence. The lobby or lobbies have not only become more organized and effective: they have virtually extended into government itself. Intelligent and energetic administrators want a role for themselves, and sponsorship and defence of 'their' industries becomes a way of life. Institutional structures of this kind become very powerful in presenting and pleading the case for support or protection of specific industries.

### International institutions and treaties

The most important juridical constraint on Britain is membership of the European Community, which has led to adoption of the Community's agricultural policy and its common external tariff, along with tariff-free trade within Europe. Membership has also led to the growing use of national VRAs and subsidies as ways of escaping complete Community control over trade policy. Finally, a permanent negotiation has resulted with other members and the Commission over the development of the common commercial policy and the proper relations between national and Community policies. One of the outcomes of that negotiation has been Community negotiations with Japan.

The GATT provides a looser framework than the Treaty of Rome, but one that involves a far greater number of countries. Its most important effect has been on the bound tariff level of the European Community via multilateral negotiations over tariffs.<sup>2</sup> GATT articles and codes have, however, also exerted an important effect on British commercial policy even when they have been breached. Thus the widespread use of the costly and arguably ineffective device of the tacitly-negotiated VRA can be explained in part by the GATT's prohibition of discrimination. The Multi-Fibre Arrangement negotiated under the GATT's auspices also constrains European Community (and therefore British) commercial policy in important ways. Meanwhile, the Organization for

1. For a discussion of the British political process and protection, see *ibid.*, chapter 8.

2. There is an enormous literature on the GATT. See, in particular, Kenneth W Dam, The GATT: Law and International Economic Organization (Chicago and London: University of Chicago Press, 1970), and Robert E Hudec, The GATT Legal System and World Trade Diplomacy (New York: Praeger, 1975).



Economic Cooperation and Development (OECD) is relatively unimportant in the case of trade policy, except for the export credit consensus negotiated under its auspices.

### International relations

The power and policies of other countries matter. What can be done with impunity to Mauritius may be difficult in the case of China, and is likely to prove impossible in that of the United States of America. At the same time, the more different are the country's policies from those of Britain, the easier is it to justify protection.

The threat of retaliation is probably the most important single influence on a government's desire to avoid protection, so that the retaliatory power of a country tends to determine Britain's policies towards it. It is no surprise that high overt protection is concentrated on exports from Japan, developing countries, and state trading countries. Here, differences in useable power and comparative advantage exert a combined effect. It is true that the pressure of comparative disadvantage in a major sector can sometimes outweigh the fear of repercussions, as has been shown by the European Community's obstinate adherence to the common agricultural policy, despite American objections, but where less politically powerful lobbies are involved even in the textiles and clothing industries, the tendency has been to control small developing country suppliers and leave larger developed ones alone. The importer can get it wrong, however, as happened in 1980, to Britain's surprise and displeasure, when Indonesia retaliated against British restrictions on imports of clothing.<sup>1</sup>

The policies of other countries affect British and European policy via the principle of reciprocity. Strong objection is made to liberal trade with countries which have much higher barriers to trade than Britain or enjoy large trade surpluses with it. An example was the fuss over the import of cars from Spain whose tariffs are higher than Britain's.

### Assessment of policy-making

The trade policy that can now be observed was not planned and has little internal coherence. There are, nevertheless, certain underlying elements.

Pressure for protection arises whenever producers are faced with an apparently irresistible comparative disadvantage in a particular sector, and so tends to be greatest where trade with markedly different countries is concerned. What is involved is

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1. See Gerard Curzon, 'Neo-Protectionism, the MFA and the European Community', The World Economy, September 1981, p. 261.



also more than a desire to reduce adjustments costs. There is powerful resistance to the basic idea of specialization on the lines indicated by comparative advantage.<sup>1</sup> Meanwhile, the United States makes up for the most important single weakness of the

The government of the day is an important factor. In the past ten years, there has been a general shift among politicians towards protectionism. This move was particularly obvious in the late 1974, but there are also strong mercantilist and protectionist sentiments within the present government, lying uneasily with a general prejudice towards liberalism. These contradictory forces have revealed themselves in an inability to take any strong positions and have led to a 'pragmatic' policy that consists largely of conserving the legacy of past confusion.

Membership of the GATT and the European Community predetermines the bulk of trade policy. Britain has lost control over important instruments of policy - the tariff, in particular - and over policy in key sectors - especially agriculture, textiles and clothing, and steel. Meanwhile, many of the countries whose policies and resources are most different from Britain's lack retaliatory power. For that reason, the economic conditions that create protectionist pressure, and the political realities that make resistance to those pressures unattractive, tend to coincide. <sup>Costs of trade policy for Britain</sup> international trading system as a whole.

#### SECURITY ISSUES AND TRADE WITH EASTERN EUROPE

Trade with Eastern bloc countries raises questions that go beyond those of economic efficiency. Even from a myopic national point of view, it could be dangerous to become dependent on imports from a potential enemy or to supply it with goods that increase the threat. Moreover, from the point of view of the international trading system as a whole, there is little reason to incorporate powers that cannot abide by the logic of a market-based economic system, whose own policies are likely to disrupt it, and - worst of all - have little interest in seeing the system work well, just because it is so important to the health of the West. In retrospect, Stalin's decision not to participate in the IMF, the World Bank or the GATT after the second world war was one of the few favours he ever did the West.

<sup>1. See the 'Omega Report on Foreign Policy', p. 26-29 (London: The West has, however, found it very difficult to agree on policy towards Eastern bloc countries, largely for mercantilist reasons leading to the remarkable spectacle of Western European governments - including our own - providing subsidized exports of</sup>

1. This is one of the principal conclusions of an important paper on British commercial policy vis-a-vis developing countries by Vincent Cable and Ivonia Rebelo. See Cable and Rebelo, Britain's Pattern of Specialization in Manufactured Goods with Developing Countries and Trade Protection, World Bank Staff Working Paper No. 425 (Washington: World Bank, 1980) especially pp. 52-3. <sup>of most modern protection.</sup>



capital goods and foodstuffs to the Soviet Union. Indeed, the Soviet Union receives many of these products at lower prices than do citizens of the European Community. Meanwhile, the United States makes up for the most important single weakness of the Soviet system by supplying large quantities of grain as, indeed, do other Western countries.

On the import side, perhaps the greatest danger is posed by the growth of the Eastern bloc's subsidized shipping and rail transport sector. In times of hostility, a large merchant marine can prove of great importance, as events in the Falklands showed. Paradoxically, subsidized Western exports of ships has helped to create this cheap Eastern bloc shipping.

In all, the basis for trade with Eastern Europe needs comprehensive re-examination, in order to find a policy other than that of selling the rope from which the noose will be made for our own necks.<sup>1</sup>

#### COSTS AND CONSEQUENCES OF POLICIES AFFECTING BRITAIN'S TRADE

Policy affecting Britain's trade must be considered both for its consequences for Britain alone and also for its effects on the international trading system as a whole.

#### Costs of trade policy for Britain

Present policy appears to be very costly. Subsidies to coal, steel, and shipbuilding run into hundreds of millions of pounds each. The cost of the agricultural policy to British consumers has been estimated at £2,800 million.<sup>2</sup> Again, for the same year the cost to British consumers of high prices of imported cars has been estimated at £1,400 million.<sup>3</sup>

What is far worse is that the policy instruments increasingly in vogue combine uncertain protective benefit in some cases (because of the possibility of trade diversion)<sup>4</sup> with huge

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1. See the 'Omega Report on Foreign Policy', p. 26-29 (London: Adam Smith Institute, 1983).

2. See Samuel Brittan, 'Pym falls into an old trap'. Financial Times, London, 13 October 1983, citing figures from the Institute for Fiscal Studies.

3. See Hindley, op. cit., p. 154.

4. See Robert E Baldwin, The Inefficiency of Trade Policy, Essays in International Finance No. 150 (Princeton, New Jersey: International Finance Section, Department of Economics, Princeton University, 1982) for a discussion of the futility for its stated purposes of most modern protection.



transfers to suppliers abroad in other cases. Such transfers are, indeed, the bribe that makes VRAs acceptable to the exporter, but lead to such situations as the British government compelling Japanese, South Korean, or Taiwanese businessmen to exploit British consumers.

The economic cost of protection to a country as a whole is the sum of the deadweight efficiency losses that result from distortions in the pattern of production and consumption, and the transfers abroad (with internal transfers netted out). In the case of the common agricultural policy, the transfer abroad that results from the difference between the higher prices paid by British consumers on community produce and the proportion of that sum received by British farmers was estimated at £1,250 million in 1980.<sup>1</sup> Of the £1,400 million cost to consumers in the form of high car prices in 1980, well over half went to car manufacturers overseas. Another scholar has estimated the total economic cost to Britain of tariffs and quotas on imports of textiles and clothing in 1980 at £500 million.<sup>2</sup> Thus, while comprehensive estimates do not exist, the sum of the deadweight losses and transfers abroad that are created by all restrictions affecting imports into Britain are unlikely to have been less than £4,000 million in 1980, or £70 for every resident of the country and £280 for a family of four. This figure, it should be remembered, represents not the cost to consumers, which is much larger, but the losses to Britain over and above the internal transfer to the protected beneficiaries. It consists, in other words, of potential income that is simply thrown away.

Quite apart from the costs imposed on the economy, there is also an important constitutional issue. It is fundamental to constitutional democracy that decisions to tax and spend are taken in public by a parliament which represents the people. Was this not the issue over which the Civil War was fought? Yet in the case of VRAs, in particular, decisions to tax, to subsidize, and to transfer income abroad are being taken covertly either by industry associations under government connivance or by ministerial fiat, without any estimate of the costs and without any discussion of the alternatives. Furthermore, it must be remembered that the government is not resisting a tide of unwanted 'enemy products', as producer lobbies like to portray imports. Every Japanese import represents the voluntary purchase of a British citizen, whom the Japanese producer cannot coerce. The British government is prepared, however, to prevent the consumer from buying what he wants. In sum, this sort of trade policy is not merely economically costly but constitutionally subversive and redolent of arbitrary despotism.

(b) Economic progress depends on continued growth of world  
1. See Samuel Brittan, loc.cit...

2. See Cable, Protectionism and Industrial Decline, op. cit., p. 123. See Jones, op. cit., pp. 7-8



### Britain's trade policy and the international trading system

How does British policy look from outside? One analyst has argued that quantitative restrictions in 1980 only affect seven per cent of British imports or eleven per cent if trade with the European Community is excluded.<sup>1</sup> This seems to be a low proportion but such figures are, in fact, of questionable significance, for the greater the effectiveness of a restraint the smaller the proportion of trade that is visibly affected. Nor do the figures reveal the economic costs of the restraints: but they do suggest an important truth. Britain is certainly not a highly protectionist country; and the present government has, despite the recession, resisted the temptation to allow its inheritance to deteriorate markedly.

The worrying feature of the international trading system as a whole is the continuing trend not only towards greater protectionism in the form of opaque and illegal devices like VRAs, but towards greater uncertainty for all participants. One of the most important sources of this concern has undoubtedly been the palpable shift of the European Community in an inward-looking and protectionist direction during the 1970s. Britain played an important - perhaps decisive - role in bringing about this shift. The present government has, however, done little or nothing to reverse the direction of Britain's influence: and indeed, when new issues have arisen - the renegotiation of the MFA and recent conflicts with Japan, for example - it has tended to continue in the same direction. In effect, its contribution has been to allow things to get worse more slowly. Lacking the courage to reverse the dangerous precedents of the 1970s that is, no doubt, all it can do.

Barriers thwart future growth. Much of the new protection is directed at countries other than the principal industrial democracies, except for Japan. It may be argued, therefore, that one of the main functions of the trading system - to keep the Western democracies together - has not failed. It may even be argued that so long as trade remains liberal within the North Atlantic region, careful control over trade with the rest of the world is not bad but even quite desirable.

This seductive line of reasoning is short-sighted and dangerous, for three reasons:

(a) The 'outsiders' against whom the established industrial countries wish to protect themselves are the advanced market economy countries of the future. As such, they are potential allies and friends. Whether they will become so, however, depends on how they are treated now.

(b) Economic progress depends on continued growth of world trade, with exchange between advanced market-economy countries

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1. See Jones, op. cit., pp. 7-8



and the rest of the world offering opportunities for all.

(c) It is difficult to preserve liberal trade in just one corner of the world economy, as conflicts within the European Community over subsidization and between the European Community and the United States already show. Once the principle of liberal trade has been abandoned, any source of difference between countries, however slight, will come to seem much worse.

In sum, the international trading system is now in a fragile state. Britain has, unfortunately, become a part of the problem and is, if not a voice for international disorder, a less than innocent bystander. It has used its position in the world as a whole and in the European Community for harmful policies that are inconsistent with the political and economic goals espoused by the present government. The reason for this failure is that there is no coherent trade policy: just a succession of ad hoc compromises, lacking in economic justification, but dictated by political expediency and a muddled mercantilism.

Meanwhile, the governments that were assumed to be perfect spawned one market imperfection after another: shovels all in the labour market, but also via the legislation of state and private monopolies, regulation, and protection. As one recent commentator has noted, '[We] all swallow immense doses, bred and reared by ourselves, and strain at a few gnats with our anti-trust'.

In the present chapter competition policy and company law are analyzed. The discussion below starts with competition policy, dealing first with the European Community and then with British policy on monopolies and mergers and on fair trading. It proceeds to company law, dealing again with both European Community directives and British law.

## COMPETITION POLICY

The most important component of an effective competition policy is commercial policy and that, as has been noted, is increasingly designed to halt competition. If that is what the right hand is doing, what is the left hand doing to increase competition?

### European Community competition policy

European Community competition policy has two principal aspects: restraint on actions by governments of member countries that lead to distortions of internal competition is the first; the second

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1. Arthur Shenfield, Myth and Reality in Anti-Trust, Fourteenth Wincott Memorial Lecture, Occasional Paper 55 (London: Institute of Economic Affairs, 1983) p. 16. This pamphlet provides an excellent exposition of the futility of anti-trust policy.



### 3. CONFUSION OF COMPETITION POLICY

The competition policy that presently affects Britain is a disease masquerading as a cure. It is not applied where it would be most useful and where it is applied it tends to be damaging. With a few major exceptions, the European Community's competition policy is equally defective.

The idea of active competition policy was born in the United States at the turn of the century and was the product of intellectual confusion. Inquiring minds had noticed that, although it was theoretically possible for markets to be perfectly competitive, in practice they were not. Meanwhile, although virtually nobody had argued - even in theory - that governments could be perfect, they were assumed to be so. Thus, the powers of imperfect governments were enhanced in order to rectify the defects of allegedly imperfect markets.

Meanwhile, the governments that were assumed to be perfect spawned one market imperfection after another: above all in the labour market, but also via the legalization of state and private monopolies, regulation, and protection. As one recent commentator has noted, '[We] all swallow immense camels, bred and reared by ourselves, and strain at a few gnats with our anti-trust'.<sup>1</sup>

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consists in curbing the anti-competitive activities of firms.

Under Article 92 of the Treaty of Rome, '... any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market'. Furthermore, under Article 93, the Commission or any Member State may act against such aids and in the last resort may take the offending government before the Court of Justice.

These valuable restraints on the freedom of government action suffer from weaknesses. Thus 'aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious unemployment' (Article 92, 3, [a]) is considered compatible with the common market. So is 'aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest' (Article 92, 3, [c]); and 'such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission' (Article 92, 3, [d]).

Despite these limitations on the powers granted by the Treaty of Rome, the unwillingness of the Commission to take action in some cases, and the refusal of governments to act expeditiously on decisions of the Court of Justice in others, these have proved to be valuable powers. Britain, for example, had to abandon the Temporary Employment Subsidy because, it was argued, too great a proportion of its benefits went to textiles, clothing, and footwear. Yet in highly political sectors like steel, coal, and shipbuilding national aids continue to be important and the effective exercise of Community restraint upon them is very difficult.

Articles 85 to 90 of the Treaty give the rules that apply to undertakings. Under these powers, the Commission has engaged in a number of actions against firms; for example, against restrictions on resale across national borders within the European Community. There has also been a long-running case against IBM. Recently, the Commission has become concerned about the price differences on cars within the European Community. On balance, however, activity against firms tends to look like harassment, with negligible, if any, effect on competition in the market place, especially when set against the continuing efforts both of national governments and of the Commission to stop free competition in other ways.

### **Britain's competitive policy**

The two principal arms of British competition policy are the Monopolies and Mergers Commission and the Office of Fair Trading. Of the two, the former is by far the more objectionable because



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it is based on a law that provides a license for administrative despotism.

The principal problem is the vague, indeed theoretically empty 'public interest' clause in the legislation on monopolies and mergers. As Edward Du Cann is reported to have said recently, 'We simply do not know, from month to month, from minister to minister, what aspect of the public interest will be uppermost in the mind of the adjudicator'.<sup>1</sup> But in addition to that defect, there is also the theoretically irrelevant assets test as well as a definition of dominance that takes no account of potential competition, especially from abroad, and is, in any case, ridiculously low.

More acceptable are those aspects of the law that deal with established abuses and attempt to rectify them rather than judge *ex ante* what problems may emerge if certain actions are permitted. This is the function of the Office of Fair Trading.

#### COMPANY LAW

Company Law in Britain is firmly rooted in liberal economic principles. 'Caveat emptor' rules and government involvement is more or less limited to registration, public filing of information, power to inspect, and the Official Receiver. At the same time, the processes whereby a company can be registered are simple, well understood and easily accessible. Furthermore, companies have wide latitude in the way they order their internal affairs, but the model Articles of Association provided by Table A of the Companies Act 1948, and a wealth of non-statutory legal form and precedent, provides much uniformity of practice. Finally, the courts have displayed a strong disinclination to be drawn into substituting their judgement for that of the businessman on business and commercial matters.

During the past couple of decades, the most useful and successful additions to British company law have been those which have improved the quantity and quality of the information published by companies. The least successful are those which have sought to enhance the protective elements of the Companies Act, or which seek to use company law for inappropriate purposes, such as the protection of employees.

There is a growing awareness of the need for reform and improvement in the following areas:

(a) There is a considerable dissatisfaction with the service provided by the Registrar of Companies, and clear scope for contracting out a considerable part of the record-keeping aspect of its work, in order to improve it, without at the same time increasing the public payroll.

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1. See the Financial Times, London, 22 October 1983.



(b) Technically, the statutes relating to companies are a mess, having last been consolidated in 1948. Consolidation is now at last under way, and a mechanism for getting this largely technical material through with the minimum loss of parliamentary time has been devised. The unfortunate consequence of this attempt at legislative efficiency is that the scope for amendment is limited, and whilst the new statutes will be a great technical improvement, quite a number of worthwhile reforms (for example, the introduction of shares of no par value) will once again be deferred.

(c) The main threat to desirable flexibility of British company law stems, however, from the European Community's harmonization programme. If ever fully implemented along the lines on which it has been developed this programme would, at any rate for public companies:

- \* standardize many technical elements (for example, Articles of Association and accounts); and

- \* introduce significant new concepts, such as the recognition of employees as organs of a company with rights and privileges enjoyed by no other class of people, providing thereby a force for reaction at a time when rapid and radical change is extremely urgent.

Many of the items of the programme (for example, standardization of prospectus requirements) would introduce greater direct public control. Moreover, they are exactly the sort of requirement that a properly functioning market would itself standardize. In any event, common prospectus requirements will never have the claimed effects of creating a European capital market while exchange controls persist.

#### FUNDAMENTAL OBJECTIVES

#### ASSESSMENT

As presently practised both by the European Community and the British government, competition policy directed against firms is more than otiose; it is an instrument for harassment and - still worse - for arbitrary interference in the exercise of property rights under the guise of an undefined and undefinable notion of 'public interest'. At the same time, one aspect of European Community policy is at least potentially valuable: namely, the attempt to control those practices of the governments of member states that threaten to distort the common market. Unfortunately, this effort comes up against the reality that makes competition policy that is addressed largely to private firms absurd. It is governments - including parts of the European Community Commission itself - that are responsible for most, if not all, of the many barriers to free competition in the market place. A competition policy that does not start with an awareness of that reality is likely to offer little if any economic benefit.

Howe, 'Agenda for Liberal Conservatism', *The Journal of Economic Affairs*, London, January 1983, pp. 71-83.



#### 4. TOWARDS A NEW STRATEGY

The policies discussed in this report are concerned with competition in the market for products. Commercial policy, in particular, is by far the most important single determinant of the extent, the vigour, and the economic efficiency of competition. This simple - indeed obvious - point seems to have been almost entirely ignored by the present government. Thus Sir Geoffrey Howe in an article entitled 'Agenda for Liberal Conservatism', written while still Chancellor of the Exchequer, makes virtually no mention of trade policy.<sup>1</sup>

Because the government fails to see that commercial policy is essential to the success of its strategy, the issue is pushed off-stage. Trade policy is used to placate politically powerful interest groups that are adversely affected both by the government's own monetary policies and by changes in the world economy. The result is an incoherent policy. Meanwhile, a competition policy that is not based in free international competition not only has little to do with the promotion of efficient competition, but encourages arbitrary and inconsistent interference in the market.

The discussion in the present chapter proceeds as follows: first, the fundamental principles that should guide Britain's trade and competition policies are advanced and defended. Then, changes are proposed in those areas where Britain can determine its own policies. Next, Britain's role within Europe and the world is discussed. Finally, reforms in the institutional structure and procedures of the British government and of the European Commission are explored in broad terms.

#### FUNDAMENTAL OBJECTIVES

The guiding principles of commercial and competition policy are considered below.

#### Policy from a national perspective

It is in Britain's interest to pursue a liberal and predictable trade policy. There is no justification for favouring one economic activity over another, except where clear and well-developed economic arguments for such exceptional treatment can be advanced. Furthermore, exceptional treatment should be granted in ways that are themselves predictable and are transparent not only to all the economic agents concerned but - equally important - to the public at large. Equally, exceptional treatment should be granted for limited periods and only after public discussion of the justification.

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1. See Sir Geoffrey Howe, 'Agenda for Liberal Conservatism', The Journal of Economic Affairs, London, January 1983, pp. 71-83.



Simple honesty requires that those in charge of trade policy should not use specious arguments in order to justify the exercise of their coercive powers in favour of particular interest groups. At the least, whenever such a policy is being followed, it is necessary to make the costs visible, instead of hiding them away behind VRAs, safety regulations, and other administrative devices. Subsidies are the least unacceptable instruments of trade policy - provided, of course, that they are not open-ended - followed by tariffs. VRAs are economically grotesque, not least because they lead to the export of what most economists would regard as the only justification for protection, namely, the revenue that can be derived from taxing foreigners.

**Need for education.** Governments can do much more to explain why liberal trade is the best policy, by stressing that protection shuffles income from one group to another within a country and has virtually nothing to do with penalizing foreigners. Protection is equivalent to a multiple exchange rate system, in which the relatively less protected, of whom exporters are perhaps the most important, pay for the higher rewards of relatively highly protected activities. It should also be pointed out that, while in the short term protection will afford windfall gains (or avoid windfall losses) for those engaged in the protected activities, in the long term the waste of resources will dominate such redistributive effects. In other words, a policy of continued protection for a particular sector makes almost nobody better off in the long term.

Britain's actual approach may be described as follows:

'The main continuing themes of policy are two. First, there is the repeated emphasis on the **general** benefits which accrue to this country from the maintenance of an open and liberal world trading system. Second, there is the awareness of what are seen as **specific** advantages arising from *ad hoc* measures to restrict imports and promote exports, even when they are inconsistent with liberal norms.'<sup>1</sup>

**Clearer thinking.** The policy consists, in other words, of asserting that 'we are in favour of free trade, but...'

Many different arguments are given for this lack of a firm and predictable policy. For example, 1983 a memorandum by the then Secretary of State for Trade and Industry to the National Economic Development Council states 'Our industry would be at a competitive disadvantage if UK government assistance were

1. The quotation is from P D Henderson, 'Mrs Thatcher's Old-Style Dirigisme', The Journal of Economic Affairs, London, January 1983, p. 129.



significantly less than that provided in other countries'.<sup>1</sup> This is fallacious. Since assistance to 'our industry' can only be given at the expense of taxation of some other of 'our industries', 'our industry' cannot be helped overall by such assistance. The policies of others are irrelevant.

Consider the following little parable: two young men, John and James, are both wooing Juliette, a lovely girl who prefers tall men. Lucky John is six feet tall but poor James is only five foot six. In order to compete more effectively, James has six inches chopped off his left leg and grafted onto his right. Unfortunately, he still fails to win the love of Juliette and cannot even walk properly any more. No wonder that a country following an analogous trade policy has not performed very well.

The nature of the fallacy was pointed out by Adam Smith, who remarked that action against trade distortions of other countries may make sense if repeal can be brought about thereby but 'when there is no probability that any such repeal can be procured, it seems a bad method of compensating the injury done to certain classes of our people, to do another injury ourselves not only to those classes, but to almost all other classes of them.'<sup>2</sup> Since Adam Smith, the statement advanced by that Secretary of State would be recognized as fallacious by any able undergraduate student of economics.

Arguments for protection often concentrate on bilateral deficits with countries like Japan, but bilateral balances are of no importance. There are virtually no assumptions under which Britain, would be better off by restricting imports from Japan than by letting them in. If Japan does not export to Britain, its resources will not lie idle: Japanese businessmen will sell in other markets and so will compete with Britain's exports. At least when Japanese products compete with domestic import substitutes, there is a potential real income improvement for Britain through the lower prices of goods that Britain buys: no such gain arises when Japan displaces British exports but there is, on the contrary, a real income loss. For similar reasons, the argument that Japan would reduce the adjustment problems in its industrial country trading partners by increasing its imports is wrong. Where will the resources released from its import-competing industries go? Unless macro-economic policy is changed, the answer is that they will go into exports. If Japan both imports and exports more, however, the adjustment problems of the rest of the world will increase, not decline.

It is the more remarkable that the British government believes

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1. The quotation is from 'Industrial Policy', memorandum by Secretary of State for trade and industry, NEDC (83) 49, 21 September 1983, p.2.

2. The quotation is from Adam Smith, The Wealth of Nations, op cit., Vol. 1, book IV, chapter II, pp. 490-1.



such nonsense when Britain is also responsible for an economy that eschews fashionable interventionism, namely Hong Kong. Indeed, the People's Republic of China permitting, Hong Kong's income per caput will almost certainly surpass Britain's before the end of the century, although Hong Kong had been a ruin after the second world war. This achievement, it may be noted, is despite a deficit with Japan in 1980 equal to one-fifth of Hong Kong's total exports and also despite the absence of any attempt to offset 'the competitive disadvantage' of industrial assistance in other countries. By way of contrast, Britain's deficit with Japan in 1980 was just over two per cent of its exports and was, indeed, only sixty per cent of Hong Kong's in absolute size.

Protection and employment. Sometimes it is argued that protection will reduce unemployment, at least in a recession. Economic change is continuous, however, while protection is a tax on one sector in the interests of another. Protection may help employment in the protected sector, therefore, but only at the cost of greater difficulties elsewhere. Fundamentally, unemployment may be caused by labour market rigidities, which protection will worsen, or by macro-economic policy. Protection is an irrelevant cure, therefore, even if it is strictly temporary and so designed solely to lower adjustment costs. In practice, however, the situation is worse since protection is virtually never temporary.

In sum, there are few good arguments in principle for the interventionism that is favoured by those in charge of Britain's trade policy, fewer still in favour of protection, and none at all for the specific types of protection employed. Governments wish to preserve the discretion to scratch a political itch and call this desire 'realistic'. The result is a policy that, lacking a firm direction, is buffeted by every political wind. To 'judge things on their merits' generates not only irrationality but, over time, the steady erosion of the liberal system, which can be defended only by continued adherence to principle in the face of sectional pressures.

The underlying principles of domestic competition policy should depend, first of all, on commercial policy. If a predictable and liberal trade policy were followed, most competition policy would be redundant, for it would be almost impossible to sustain any sort of global cartel or monopoly without inter-governmental co-operation.

To the extent that room is left for policy, it must be predictable and must deal with evident dangers. In certain cases, the two requirements go together: the abolition of agreements to fix prices, for example. In others, however, there is some conflict since the possibility of an investigation for abuse ex post may create considerable uncertainty ex ante. For this reason, the notion of an abuse of market power must be precisely defined if the law is itself not to create more problems than it attempts to remedy. Finally, no policy of promoting competition in the private sector has much justification so long as govern-



ments continue to thwart competition in so many ways. Hypocrisy is not a sound basis for policy.

### British policy from a global perspective

In its relations with the European Community, we believe that Britain should emphasize the most valuable elements in the original conception and reject the subsequent encrustation of bureaucratic dirigisme. That valuable original idea was the establishment of a European Community of free citizens enjoying entrenched economic rights against the intervention of governments.

Individual economic rights can secure the economic development of the European economy and the reduction of conflicts among member states over economic questions. Such conflicts result almost entirely from government interference in the market. Moreover, it was in order to avoid the revival of just such conflicts among European countries that the Community was established. But the achievement is now threatened by the growing tendency toward 'positive' action by states.

The interventionist element was present from the beginning, principally in the form of the obligation to form a Common Agricultural Policy. Over time, this particular redistributive policy has created greater internal and external difficulty than any other aspect of the Treaty of Rome. The experience should have warned member states of the dangers inherent in the attempt to base policy not on the free action of individuals but on the co-ordinated interference of governments. In practice, however, 'baby CAPs' - the steel cartel and the textile restrictions, for example - have spawned as governments feel obliged to intervene in defence of sectional interests. Since the conflicts tend to occur simultaneously within member countries, among them, and between them and outsiders, the growth of intervention has created bellum omnium contra omnes.

One of the consequences of the triumph of the agricultural policy germ over the body of liberal principles is that the Community ideal has fallen into disrepute. As an organization dedicated to the idea of a common rule of law, the Community could legitimately attract the idealistic support of those who had seen the ruinous consequences of European nationalism. In its economic aspects, however, nationalism consists largely of the false identification of the interests of particular producer groups with those of the nation as a whole. Across national boundaries, producer groups can only conflict or create cartels. Thus the evolving forms of Community policy reflect the rise of economic nationalism and, correspondingly, the decline of the Community's liberal ideal.

The butter mountain has become a symbol of the folly of the European Community, bearing witness to the cynical manipulation of the market for sectional purposes. Butter mountains may be



tolerated by Europeans; they may even be thought useful and necessary, but they cannot warm the heart. It is difficult to believe that the Community has a long term future as a machine for redistributing self-inflicted losses.

**Erosion of property rights.** Perhaps in order to make up for the growth of sordid protectionism, the Community has become increasingly engaged in social engineering. Directives are promulgated that will limit the ability of those who own property to use it productively. The creation of limitations on the ability of property owners to use it freely has become of growing importance in the course of this century. Parts of the Commission have leapt onto the band-wagon. At a time when tax conditions are such that businessmen throughout Europe will do almost anything rather than invest in ways that will increase employment, the Community is busily working to increase the problem. Neither governments nor the Community dare to face the truth that while legislation may define the conditions and rights of employment, it can do nothing to ensure that free agents will offer employment on those terms and conditions.

The liberal aspects of the European ideal ought to have great attraction for the British government. It could beneficially attack the growth of protectionism and dirigisme not in the name of national interest or budgetary equity, but in the name of the liberal ideal. In this way, it will be able to present itself not as a surly and half-hearted member of the Community, but as one that stands for its only promising future.

Meanwhile, Britain could promote similar ends in the international trading system as a whole. A great deal will be achieved if it liberalizes its own barriers, and still more if external barriers to trade with the Community as a whole are lowered. If these reforms can be made and if, at the same time, the tendency towards discrimination against the most successful market economies can be reversed, entirely unnecessary conflicts among those who share many fundamental values can be ended.

**Subsidies.** The subsidization of exports can be justified not so much because others do it but because it offsets the costs by protection against imports. As the latter falls, however, so should export subsidization. Furthermore, to Britain has substantial room for action on its own account on both commercial and competition policy.

### **Commercial policy**

The following measures suggest themselves, given the foregoing analysis.

- (a) A truly competitive trading nation would cease to implement existing VRAs and quantitative restrictions, replacing them, if really thought necessary by direct subsidies;
- (b) such a nation would cease to operate mechanisms to restrict



imports agreed by the European Community such as bilateral agreements under the Multi-Fibre Arrangement;

(c) prosperity would be enhanced by any move to abolish the subsidization of exports; and

(d) the effects of these changes on the profitability of production of tradeable goods could be offset by allowing a 'compensated devaluation' of the exchange rate.

**Restrictive agents.** So far as existing national restraints are concerned, nothing prevents the UK or any other government from ending them at once. In the case of motor vehicles, for example, the UK could announce its intention of treating the VRA with Japan and the restrictions on 'parallel' imports from Europe as anti-competitive distortions. One result would, of course, be a substitution of imports from Japan for those from Europe, a matter of little importance to the United Kingdom. In addition, the profitability of existing producers in Britain would be lowered as they faced more open competition. This does not mean that the true costs of sustaining British Leyland would be any larger than now: on the contrary, they would be smaller, although more direct and more visible. Both of these changes are desirable. If the government wished to continue to sustain British Leyland, it would have to subsidize it more heavily, but the UK would be spared the considerable indirect cost so consumers of VRAs.

In the case of restrictions agreed under the European Community's auspices, a member government can readily refuse to implement them where this will create no difficulty for other member countries. In the case of the textile restrictions, for example, there would seem to be nothing to prevent free import into Britain. It would certainly be possible to avoid imposing new restrictions on imports of textiles and clothing under the 'exit from the basket' provisions of the Community's bilateral agreements under the MFA. Indeed, Germany already does this.

**Subsidies.** The subsidization of exports can be justified not so much because others do it but because it offsets the costs imposed on exports by protection against imports. As the latter falls, however, so should export subsidization. Furthermore, to the extent that it is believed that the economy has grown too open and vulnerable to world trade a small tax on exports is perhaps desirable. The solution then is to lower protection against imports and abolish all subsidization of exports. At the same time, provision of market information and export credit insurance can readily be undertaken by the private sector.

The consequence of the abolition of protection and export promotion is, first, the simplification of an implicit regime of multiple exchange rates and, secondly, an exchange rate revaluation. The latter occurs because protection (and export subsidization) raise the prices and profitability of the goods affected in domestic currency terms (given the prices in terms of



foreign exchange) and work, therefore, just like a devaluation affecting those products alone. The effect of liberalization will tend, therefore, to be deflationary or - perhaps more accurately in current circumstances - disinflationary. If this is not desired, the exchange rate should fall to compensate, as indeed may be expected to occur automatically as the value of imports increases.<sup>1</sup> The depreciation of the exchange rate will stimulate the production of other goods, thus offsetting the depressing effect on the production of the previously protected and subsidized goods.

### Competition policy

British policymakers have substantial freedom of manoeuvre in relation to domestic competition policy. This could be enhanced by the removal of several existing interventions:

- (a) The 'public interest' test that runs through the practice on restrictive practices, on anti-competitive rules, on monopolies and on mergers;
- (b) the 'assets' test for referral of a merger to the Monopolies and Mergers Commission;
- (c) the test for a monopoly, namely that a business, or a group of connected businesses, holds one quarter or more of the market for a particular good or service in the United Kingdom;
- (d) ex ante screening for potentially undesirable situations; and
- (e) the ability of the Secretary of State to resolve or intervene in cases at his discretion.

The concept of 'public interest' that runs through present practice is probably the most dangerous single element. In the absence of a theory (or at least a cogent definition) of public interest, the concept is a licence to arbitrary and therefore unpredictable and costly intervention in the market. If one should search, however, for a workable definition of the public interest in this area, it turns out to be only the situation in which monopoly power is curbed and high quality products are provided at the lowest possible cost. In other words, the public interest is **competition**. For this reason the concept of public interest is either redundant or damaging in the context of

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1. It should be noted that under certain restrictive assumptions the improvement in the terms of trade following the ending of a 'voluntary' export restraint may mean that the foreign exchange value of imports falls after abolition of the restriction. A necessary condition is that the price elasticity of import demand from the restricted supplier(s) is less than unity, which is very unlikely to hold in the case of the existing 'voluntary' restraint arrangements.



competition.

At present, any merger involving the acquisition of assets exceeding £15 million can be referred to the Monopolies and Mergers Commission. The level of assets indicated in the law is absurdly low, but in any case the test is irrelevant. There is no reason why a merger that does not produce market power is against any relevant interest. The test is a standing invitation to capricious behaviour by those vested with power.

Under current rules, a monopoly is deemed to exist if one business, or a group of connected businesses, holds one quarter or more of the market for a particular good or service. This criterion is defective in that, first, it ignores potential competition, and secondly, the share itself is too low to indicate any significant degree of market power. If there is to be a criterion of this kind, account must be taken of the openness of the market to international competition and to product substitution. At the same time, the share of the market, when the latter is appropriately defined, must be raised well above a quarter.

All ex ante screening for potentially undesirable situations is an invitation to arbitrary intervention, and runs counter to the general purpose of law as it affects private decisions: namely, to penalize unjust action.

Finally, the powers to intervene that are vested in the Secretary of State are another source of the arbitrary politicization of trade, and liberal principles would suggest that they should be replaced by judicial procedures that operate in accordance with more clearly specified legal concepts.

At the same time as ending many features of existing practices, a number of new elements would need to be introduced if competition were to be more effectively promoted:

(a) the general aim should be to root out actual abuses of monopoly power, such as price cartels;

(b) if monopoly is to be retained as a reason for intervention, the concept should be considered relevant only to those industries that are shielded from international competition by natural or artificial barriers and where a company or group of companies may obtain by merger a market share of at least fifty per cent;

(c) extending the principle of competition further, public enterprises might usefully be made liable to suits against abusive practices in exactly the same way as private enterprises;

(d) the job of prosecuting abusive practices, under such a strategy, would probably be lodged with the Office of Fair Trading, but private citizens should also, in our opinion, have the right to bring cases and sue for damages; and



(e) the easiest mechanism would probably be for cases of abusive practices to be heard before an expanded Restrictive Practices Court with a right of appeal to the High Court.

Abuse of monopoly power is already the concept used in the European Community's competition policy. Its introduction in a central role into the British context would, therefore, be far from a revolutionary step. What would be needed is to define more precisely what abusive practices are deemed to be, leaving to case law the elucidation of those tests in practice.

The proposed monopoly criterion would apply to mergers that will give the new entity more than half of the market in a good or service not subject to free international competition. Growth of a firm to this size through effectiveness in the market place should not, of course, be subject to review, except if an abusive practice can be identified. Where mergers do lead to control of more than half of the market, the onus will be on those proposing the merger to demonstrate that it will bring benefits in terms of the price, quality, or availability of specified goods or services.

For the sake of credibility (but still more because of the worthwhile economic consequences) public enterprises should be subject to the same restraints as private ones. Many public enterprises are de jure or de facto monopolies by virtue of protection or natural barriers to trade. Indeed, most significant monopolies are public enterprises. Whenever an organization does have monopoly power, abuses must of course be subject to law.

It is important that both the state and private citizens have the power to take an organization to court for abusive practices. The latter, in particular, will benefit from the ability to collect actual damages, although penal damages may be imposed as well. The powers of the courts to impose damages might be a much more open and just system than the bureaucratic procedures now in place.

The purpose of all such reforms would be first, to embody economic principles in an area of government intervention where principle is lacking and, secondly, to replace bureaucratic discretion by the rule of law. Both are of fundamental importance and are the more important the more that restrictions on the free international flow of goods and services are maintained or even increased. Protection is bad; but protection without an active competition policy is worse.

#### BRITAIN, THE EUROPEAN COMMUNITY, AND THE WORLD

There is much that Britain can do on its own to increase the extent of domestic and international competition on its economy, but there are also important respects in which it is bound by membership of the European Community and its participation in



such international treaty organizations as the GATT. Because of this international dimension, there are respects in which Britain cannot necessarily do what is in its own immediate interests. At the same time, as an important - and on some occasions pivotal - member of the European Community, it has an opportunity for exercising global influence. Both aspects need to be considered.

### Internal market of the European Community

The principal economic justification for the European Community is the potential to exploit its huge internal market. From the growth in the number of cases, however, protection of one member against another appears to be increasing.<sup>1</sup>

It is important not to exaggerate the importance of a perfectly harmonized internal market devoid of all administrative barriers to trade. The high incomes and rapid growth of Sweden, Switzerland, Hong Kong, and Singapore have demonstrated that small countries can enjoy extraordinary economic success and even obtain incomes as high as those enjoyed in such huge markets as the United States. The conditions for success are that the country itself follows highly liberal policies and that the world's important markets offer no more than modest barriers to their exports. Administrative barriers and lack of policy harmonization across frontiers have not prevented these successes.

**False comforts.** A large internal market can be a snare as much as a spur. It encourages governments and industrialists to ask the following sorts of questions: 'How can a large economy like ours progress if it is not involved in technology A or industry B?' 'Surely, ours is a large enough market to ensure that, if only foreigners are prevented from entry, an efficient C industry will develop?' 'Would it not be shameful if a large economy like ours were not actively involved in the D and E technologies of the future?' And 'would a large economy like ours not be dangerously exposed if it were not self-sufficient in the strategically significant F and G industries?'

Leaders of large countries are immensely attracted by these arguments, which promise protection to industrialists, activity to bureaucrats, and painless progress to politicians. Neither Concorde nor the Advanced Gas Cooled Reactor would have been supported by a Swiss government. Similarly, it is no accident that the telecommunications firms of Scandinavia are more successful in international markets than Britain's since they have to be to survive. They cannot rely for profitability on British Telecom's purchases.

1. According to The Economist, London, 22 October 1983, p. 70, the number of cases then being investigated by the Commission was 770, more than double the number in 1981.



The larger the economy, the greater the incentive for politically-inspired waste. It is for this reason that arguments for 'Fortress Europe' - internal free trade combined with external protection - have become increasingly popular among proponents of 'industrial policy', many of whom now feel that the member states themselves are too small. A part of the impulse towards lowering internal barriers within Europe has just such an interventionist and protectionist flavour.<sup>1</sup> Proposals for future policy advanced by the French government in 1983, for example, go in this direction, and in 1979 the Commission wrote:

'Simply removing customs duties is not enough: the difficulties being experienced in certain industrial sectors and the need to develop new high technology industries require the Community to develop and implement a co-ordinated industrial policy.'<sup>2</sup>

In 1970 the Commission announced that the customs union, though it is the basis of all the rest, should be complemented as much as possible by new common instruments of action.'

Britain would be a powerful obstacle if it chose to resist the interventionist approach to the development of the internal market. Its strategy in this would undoubtedly focus its attention, instead, on developing freedom for individual action within the common market, concentrating on significant barriers to internal competition, and not permitting the 'development of the internal market' to become a codeword for external protection and internal intervention.

Given this broad goal, the encouragement of competition within the European Community's internal market would entail the following elements:

- (a) a plan for the phasing out of selective state aids to industry in the long term and for a transition to that situation in the short term;
- (b) a plan to reduce barriers to internal trade, focusing particularly on direct barriers to trade and on protectionist public procurement policies;
- (c) strong support for the thrust of European Community competition policy; and
- (d) strong opposition to the Commission's proposals for using Company Law Directives as instruments of social engineering.

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1. For the argument for Fortress Europe see Wolfgang Hager, 'Protectionism and Autonomy: How to Preserve Free Trade in Europe'. International Affairs, Summer 1982, pp. 413-28.

2. From 'The Community's Industrial Policy', European File 3/79 (Brussels: Commission of the European Communities, 1979), p. 2.



Selective aid . Selective state aids create internal conflicts, leading in turn to cartellization, internal barriers to trade, and external protection. They are also a reflection of the defensive approach to industrial policy taken by many member countries. Britain could join Germany in attacking such aids and support the efforts of the organs of the European Community - especially the Commission and the European Court of Justice - to control them. In the long term this means that Britain would (or might threaten to) block imports of subsidized products, the purpose of such action not being protection, but deterrence. If Britain were to side with Germany in many such cases the deterrence effect would be substantial.

In the short term, this policy would be hypocritical, since Britain makes very extensive use of subsidies. Furthermore, it has been suggested above that, during a transitional period, the abolition of VRAs facing imports into Britain may necessitate still greater direct subsidies for weak industries. While such subsidies are thought to be needed, Britain can pursue two alternative policies: to introduce the subsidies and attempt to agree with fellow members on a phased plan for withdrawing them (along with similar subsidies in other member countries); or not to introduce the subsidies and agree instead to raise the common external tariff on a non-discriminatory basis in accordance with the GATT's Article XIX. Both of these alternative ways of dealing with the transition have advantages and disadvantages. The choice must depend on which will create the smaller problems in the short term and which will make it easier to achieve the ultimate goal of undistorted trade.

Internal barriers. At the same time, Britain may be able to make further moves to lower other barriers to internal trade, focusing on the most important. Different national standards, for example, are not necessarily a problem. Indeed, it is perfectly legitimate for countries to adopt different standards and these differences may provide valuable experiments from which all can learn. Absolute uniformity may be the bureaucrats' tidy version of the European ideal: vive la difference is, within reason, not necessarily a bad slogan for Europe.

While the principle of different standards is not illegitimate, its use for protectionist purposes is. The distinction is not easy to draw, but some cases are obvious. The grant to official dealers of an effective monopoly over the import of cars into Britain, for example, which is a by-product of safety regulations, is clearly protectionist and indefensible.

Probably the most important general barrier to freedom of competition within the Community (leaving aside barriers that arise in particular sectoral contexts) is nationalist public procurement policy. Public consumption and investment account for a large proportion of total expenditure in all European economies, especially in the high-technology sectors. Moreover, procurement policy is almost universally protectionist. Along with an assault on direct barriers to trade and subsidies, there-



fore, there is a need to reach agreements to liberalize public procurement within the European Community.

**Competition.** Competition policy at the European level is more appropriate than that for Britain alone. The broad aims of Community competition policy therefore deserve support. Directives on Company Law are, however, a very different matter. The draft Vredeling and Fifth Company Law Directives both attempt to put companies in a legal straight-jacket for social policy purposes. The effect would be to increase the powers of the leaders of organized labour by expanding the former's rights to information and a voice in decision-making. While any general directives in such matters are undesirable in a free economy, the balance of these proposals is particularly inappropriate in present European circumstances and would be strongly resisted by proponents of genuine liberalism.

### Sectoral protection and the European Community

In certain sectors, there exists a cluster of barriers to internal competition and external trade, about which something needs to be done if economic and political problems are not to grow. The most important of these sectors are agriculture, steel, textiles and clothing, and - for Britain at least - services. In all of these cases, Britain could be the instrument for a radical alteration of existing policy.

**Agriculture.** Both the ends and the means of the policy of the European Community towards agriculture are indefensible. Some argue that the CAP is the one achievement of the Community. If this were true, the Community would not be worth very much, but fortunately it is not true: the main achievement of the Community is liberal internal trade. Others - even members of the present government - argue that the CAP benefits consumers by increasing the availability of food and giving a 'guarantee' of supply. The high prices must, however, lower consumption in the Community with the increased availability serving only to create surpluses. Meanwhile, the value of any guarantee depends on the risks and the costs. Who would pay £10,000 for a guarantee that a new £4,000 car would never break down in the first five years of life? Since European Community prices have virtually never been below world levels, this is a costly 'guarantee'.

The Common Agricultural Policy is a system for raising prices, and as such, is inefficient and regressive. Its main effect is inevitably to turn rich landowners into very rich landowners. (The principal impact of subsidies to agriculture is on the value of land, and, in this case, the larger a farm's output, the more its owner receives.) In its assault on the CAP, however, the British government has focussed much more on its budgetary implications than on its economic costs, although the budgetary flows are virtually irrelevant to an overall assessment of the costs of the CAP.



The ideal policy is to have a complete free market in agriculture,<sup>1</sup> but if governments must support agriculture, the best policy consists of:

- (a) deficiency payments (up to a maximum limit per farmer) for income support with no intervention in prices, plus,
- (b) official stock-holdings in order to guard against the risk of an unanticipated curtailment of supply.

We propose such a policy for the future. If agreement cannot be reached on a Community policy on this basis, nationalization of deficiency payments, with transfers of income to poor countries like Ireland being secured by other means, would be a practicable second best approach.

A third-best policy would be to replace the CAP by tariffs, the tariffs being designed to equalize effective rates of protection. A tariff allows prices to respond to market conditions and limits the effect of intervention to that of achieving complete self-sufficiency. As a result, there would be no surpluses to dump or store. Unfortunately, high common tariffs would be costly for Britain as a food importer and are, for that reason alone, less attractive than its historic policy of low food prices.

**Steel.** In the case of steel the Community has created a cartel to enhance profitability and make national subsidies less necessary. In order to support the cartel, it has reached agreement on export restraints with all major external suppliers. The aim of competition policy should of course be to end the cartel, the subsidies, and the export restraint arrangements. If the industry must be supported, however, subsidies are better than any device for raising prices, since those higher prices affect adversely the entire European Community steel-using industry. A consistent British policy towards steel would consist of the following:

- (a) scaling down subsidies by 1985 in accordance with European Community plans;
- (b) refusal to co-operate in the cartel beyond that date;
- (c) an insistence on the abolition of VRAs on steel at that time, balanced by a willingness to take anti-dumping or countervailing action against subsidies, where justified, at the European Community level; and
- (d) blocking imports of European Community steel products that are recognized by the European Community to benefit from state aids.

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1. See the Omega Report on Agricultural Policy, (London, Adam Smith Institute, 1983).



The above is the optimal solution, if the aim is to achieve a return to the free market as quickly as possible (with the barriers to intra-Community trade being designed to encourage a reduction of subsidies in other member countries). If this is not feasible, however, a second-best policy might include a modest rise in the tariff against imported steel under GATT's article XIX, and an agreement to limit, but not end, subsidies. In either event, the cartel would be abolished. Not only is a price-raising cartel of its very nature more likely to increase than lower excess capacity but, in this case, the cartel makes inevitable an acrimonious debate over the 'just' allocation of production cutbacks. In consequence, one hears economically illogical arguments to the effect that since Britain, for example, has cut capacity by a certain percentage so should other member countries, regardless of the relative efficiency of the plants affected.

**Textiles.** While subsidies to textiles and clothing have not been insignificant, the main feature of support for these sectors is the complex web of restraint arrangements under the MFA. The latter has now been renewed twice and is itself the heir of arrangements that go back to 1961. If the time has now come to escape from this apparently endless procession of increasingly severe discriminatory restrictions, the abolition of restraints on imports into Britain could be assisted by:

- (a) the ending of the MFA arrangement and of European Community bilateral agreements under it; and
- (b) the replacement of these restrictions by an increase in the external tariff on a non-discriminatory basis with a plan for a reduction of the tariff over a clearly announced period sufficient to permit orderly withdrawal of resources (perhaps ten years). Subsidies are not really feasible in this case because of the number of firms involved and the heterogeneity of production.

The MFA is a source of conflict with developing countries; it embodies a major violation of GATT principles; and it is, without question, the least economically efficient means of protection for the importing country. Replacement of the MFA by the higher tariff would, therefore, be a highly desirable change, not least because it would end the four-year cycle of acrimonious negotiations.

**Services.** Finally, there is the case of services, which are affected by severe barriers to internal and external trade. The sector is very heterogeneous, including as it does transport, insurance, banking, construction, and many other activities. Britain does, however, have a clear interest in liberalizing trade in these various activities, in all or most of which it has a comparative advantage. Thus, there is every reason to suppose that Britain's surplus on invisible trade with the rest of the world would be considerably larger still if there were a widespread move to more liberal trading conditions, either in the



Community or in the world at large.

Hence, UK invisible earnings would benefit from a more forceful application of the Treaty of Rome to service transactions within the Community, and Britain would have much to gain in joining with the United States in pressing for a multilateral negotiation designed to introduce rules dealing with trade in services into the framework of the GATT. These objectives, however, are not independent. The attempt to introduce rules for trade in services into GATT is hampered in part by the lack of enthusiasm of the European Community, which in turn derives from the unsolved problems of intra-Community trade in this sector. The United Kingdom is therefore in a key position, and might profitably seize upon the opportunities in this area with a special enthusiasm.

In dealing with deeply-entrenched sectoral problems within the European Community, the British government faces serious tactical dilemmas. There is usually a trade-off between national aids and the level of external protection; there is sometimes a conflict between the domestic policy that is favoured - at least in the short run - and the policies that Britain would like to see pursued in other countries; there is often a choice between different means either of tackling the distortions created by the policies of other countries or of offsetting them; and there is even the question whether those policies of others should be offset at all. It is impossible to give any general guidance on these dilemmas. What can be stressed, however, is the importance of a consistent striving for liberalism, allowing the combination of strategic consistency and tactical flexibility.

### External relations of the European Community

European Community policies affect economic conditions throughout the world - not surprising since the Community is the world's largest trading entity. In consequence, trade policy is also foreign policy. The Community has shown an awareness of this fact from the beginning, since its array of discriminatory arrangements were motivated more by foreign policy than economic objectives.

In general, the trade relations of the European Community are either with allies or with countries with which the Community has no strategic conflict (such as developing countries). A very different problem is created by trade with communist countries.

**The United States.** The European Community's most important trade relations are with the United States. Unfortunately, there has been substantial conflict, especially over agriculture, 'extra-territorial' application of American law, and export credit subsidies. In most of these cases, it is difficult to have much sympathy with the European Community position. Indeed, the form of the CAP - let alone its highly protectionist purpose - must be a constant irritant to an agricultural exporter like



the United States. This is a good reason for moving to deficiency payments (provided they do not stimulate large exports) or tariffs. Again, much of the resistance to 'extra-territorial' application of American law hinges on the desire to promote subsidized exports (mercantilism) as in the case of the gas pipeline, or to protect domestic cartels. An egregious example of the latter is the refusal of the British government to allow co-operation with the investigation into the causes of Laker's demise. Not only is this a legitimate American interest, but the very desire to protect domestic cartels is unjustifiable. The same applies to the mercantilism that leads to subsidized exports to the Soviet Union: not only is this foolish in itself, but it is bound to irritate the country that guarantees European independence. Export credit subsidies are another symptom of mercantilism and, again, it is in the interests of the subsidizers to withdraw them. In all these cases, therefore, a reconsideration of the interests of Britain or the European Community should lead to a substantial reduction in conflict.

**Japan.** The same applies to the Community's troubled relations with Japan. The position Britain and the European Community have taken with regard to Japan is absurd, for the following reasons:

- (a) there is nothing wrong with bilateral imbalances in trade, which may be counterpoised by opposite imbalances with other countries;
- (b) Japan's bilateral surplus with the Community is less than one per cent of European Community manufacturing output;
- (c) it is desirable for Japan to have an overall current account surplus, thus lending some of its surplus savings to the world; and
- (d) the alleged low import intensity of Japan, about which the Community has complained formally to the GATT, does not increase European Community adjustment problems but lowers them, since more imports into Japan are certain to lead to even greater exports from it.

Thus the European Community (like the United States) is engaged in an economically futile conflict, whose sole effect must be to alienate a country which it is in our interests to attach firmly to the Western cause. Community policy could reverse this alienation by the following measures:

- (a) dropping all existing actions against Japan - the Article XXIII case under the GATT and VRAs; and
- (b) encouraging Japan to liberalize (for example, in agriculture) not because this will make the European Community's life easier - it will not - but because it will benefit Japan itself.

**Developing countries.** In its relations with the developing



countries, the European Community pursues what may be called the 'division of the sheep from the goats'. Developing countries receive favourable treatment through association agreements (in the case of the Mediterranean countries), the Lome Convention, and the Generalized System of Preferences, so long as there is no possibility of 'disruption', or, in other words, real competition. At the same time, competitive exports and exporters - especially the East Asian newly industrializing countries - have been subject to restraints.

The broad lines of an appropriate trade policy in relation to the developing countries, aimed at stimulating their growth and bringing the fruits of their industry to the consumers in developed nations, are the following:

- (a) the abolition of discrimination against them;
- (b) the concentration of schemes for preferential liberalization on the least developed developing countries;
- (c) removal of access limitations under preferential schemes, including those on agriculture and textile and clothing; and
- (d) pressure on developing countries to accept a more equal role within the GATT framework than at present.

**Eastern bloc countries.** Finally, there is the question of trade policy towards communist bloc countries. It is difficult to determine the balance between security and economic considerations, but the correct policy to a bloc that has no advantage in the continuance of the trading system of the West would seem to call for:

- (a) the removal of all forms of subsidy from exports to communist countries;
- (b) full co-operation with the United States in the control of exports of strategically valuable goods; and
- (c) curbs on imports of such essential goods and services as shipping and energy from communist countries.

#### **GATT and the international market economy**<sup>1</sup>

One of the most important areas for European Community policy is the GATT framework itself and the negotiations carried out within it. In a largely mercantilist world, the GATT is the only available source of order. This does not mean that it is without

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1. For a more complete discussion of many of the points raised in this section, see Kenneth Durham *et al*, Words are Not Enough: a Report on the Perils of Protectionism, (London: Trade Policy Research Centre Special Report No. 2, 1984).



defects. On the contrary, as an agreement based on mercantilist ideas, it was a tactically shrewd device for achieving liberalization, but was also strategically dangerous because of its perverse consequences for public education in the principles of international trade. The GATT, therefore, should not be used to define an appropriate policy for Britain or the European Community. Its best use is perhaps as a means of influencing the policies of others, with a view to restoring the credibility of the basic principles of a liberal international order. Policies specifically related to the GATT need to deal with the following issues if this is to be advanced:

- (a) a code on safeguard protection;
- (b) other codes, especially the Subsidies and Countervailing Duties Code;
- (c) dispute settlement; and
- (d) priorities for the next round of multilateral trade negotiations, including the issue of a rollback of protection, the place of developing countries in the GATT system, and international trade in services.

The attempt to agree on a new Code to cover resort to emergency or safeguard protection under Article XIX of the GATT foundered during the Tokyo Round. The reason for the failure was the desire of the European Community to obtain sanction for policies of selective or discriminatory protection and the refusal of a number of developing countries to accept such a codification of the nullification of GATT's most important principle. The European Community's proposal was - shamefully - initiated by Britain, the arguments advanced being that in this way the currently illegitimate practice of discrimination would become more visible and, therefore, more controllable. Experience with the Multi-Fibre Arrangement suggests, however, that discriminatory restraints, once legitimized, sprout like mushrooms. There is, indeed, no obvious reason why governments will live more faithfully by a code governing abuse of a principle than they did by the principle itself. Furthermore, there is no sound economic justification for the VRAs that are currently the most common form of discriminatory protection. We suggest that Britain and the European Community should abandon the attempt to obtain a right to discriminate in a new Safeguards Code but should focus, instead, on establishing:

- (a) multilateral surveillance of safeguard actions;
- (b) a time limit on all safeguard actions; and
- (c) domestic procedures that evaluate the costs and benefits of safeguard actions coram publico.

Meanwhile, safeguard actions, where thought justified should be non-discriminatory just because this will make it politically



more difficult to protect.

In the course of the Tokyo Round a Code on Subsidies and Countervailing Duties was agreed, the principal effect of which was to persuade the United States to abandon its valuable policy of automatically countervailing subsidies, in return for vague language defining the appropriate use of subsidies. In the event, the conflict over the effects of the subsidies to steel given by many European countries showed that the new Code does not work very well. There is a need to reconsider the Code, in the understanding that its primary aim must be to control and reduce the use of subsidies. A licence to subsidize is just as divisive in the international arena as it has proved within the European Community.

There have been many complaints about the unwillingness of the European Community to accept a binding form of dispute settlement procedure and still worse, about European Community arm-twisting of weaker nations within the GATT. It is almost universally true, however, that what other countries complain about are actions by the European Community that are against its own interests. For this reason, the idea of more authoritative dispute settlement procedures is in the economic, let alone the political, interests of the Community and needs to be supported.

Finally, the Community must consider where the GATT is going, where it should be going, and what can be done to bridge the gap between the two. The problem is that existing precedents for protection make any pledges to future temperance look no more than pious hopes. The future stability of the system will not be credible if existing violations are not rolled back in textiles and clothing, in steel, in the whole area of VRAs, and even in agriculture. For this reason the proposal of the European Community that Tokyo Round tariff reductions - modest in themselves - might be accelerated in countries attaining two per cent growth rates in GDP, is ludicrous in its irrelevance to the main issue. It is, indeed, an attempt to change the subject from that of what to do about existing sectoral systems of protection and discriminatory restraints. This must be the focal point of the next round of negotiations and the European Community's contribution should be a willingness to liberalize in just these difficult areas.

**Pressing questions.** Within the context of such an approach to future negotiations, the Community may wish to focus on two particularly pressing questions: trade in services and the participation of developing countries in the international trading system.

The first of these issues is an American priority, but it is one in which Britain has an interest. In the context of efforts to get the Community to liberalize internally, Britain must gain from any response to the idea of international liberalization in services. Whether such liberalization could best be carried out within the GATT framework is another matter. Certainly, the



extension of liberalization to services within the GATT should not detract from efforts to repair the existing system.

Developing countries have achieved a very special status in the GATT system. The result has been not only an undesirable confusion of trade and aid, but a loss of the most important property of an appropriately functioning liberal international trading system - namely, automatic rather than negotiated accommodation to change. Within the context of a commitment by developed countries to a roll-back of existing discriminatory protection, they must persuade developing countries - especially the more advanced - to play a more equal part in the GATT and accept the value of GATT disciplines to themselves.

#### INSTITUTIONAL REFORM

The above proposals are undeniably radical, as they need to be, and demand some change in the allocation of institutional responsibilities for trade and competition policy, and in procedures for determining policy both in Britain and the European Community. The most important institutional changes contingent on the strategy outlined above would be the ending of current the export promotion functions by official agencies, or their privatization, and the replacement of existing monopolies and mergers apparatus with expanded versions of the Office of Fair Trading and the Restrictive Practices Court. But such organizational changes are fairly modest compared with the changes in strategy. Far more important in bureaucratic terms is the eradication of those parts of the Department of Industry that have any responsibility for specific industries (along with the NEDO) that it would be possible to accomplish if the traditional framework were replaced by a determination to promote general competition and avoid selective protection.

#### INSTITUTIONAL REFORM

The proposals considered above are undeniably radical, as they need to be if more open international trading is to be encouraged, with the benefits that it brings to consumers in all countries. They would make possible a number of changes in the allocation of institutional responsibilities for trade and competition policy, and in procedures for determining policy both in Britain and in the Community context.

The most important institutional refinements and simplifications that would be made possible by the strategy outlined would be those associated with the curtailment of existing export promotion functions by official agencies, or their transfer to private bodies, and the structures that are needed for a less arbitrary system for controlling mergers and monopolies. But far more substantial in bureaucratic and cost terms would be any elimination of the existing institutional structures that have responsibility for specific industries, both in NEDO and the



Department of Trade and Industry, that would become possible if the traditional interventionist framework were replaced by a strategy of more general and open competition.

A movement along these lines could, we believe, make possible a substantial number of bureaucratic simplifications and refinements which could be summarized as follows:

(a) as export promotion ceases to be a concern of government, and is left to the industries who have most to gain from it, the British Overseas Trade Board would lose its raison d'etre;

(b) as market intelligence and the responsibility for obtaining information on projects is left to those who benefit, most of the Projects and Export Policy Division would become unnecessary, though sections dealing with the Eastern bloc will still be required;

(c) advice on exports to North America is not a necessary function of official agencies, since British businessmen operate there every day. The same principle holds true of relations with Japan and Korea. Thus, Overseas Trade Division II becomes unnecessary and could be dissolved;

(d) the same general principle applies to Overseas Trade Division III, since the 'co-ordination of export services policy' and market intelligence gathering is not, as we have seen, required under a liberal trade strategy. Some items, such as branches dealing with exports to Europe, special exports, export data, and fairs and promotions, seem good candidates for transfer to private sector bodies, some of which already exist to undertake precisely these functions;

(e) only sections dealing with East/West trade and China would be necessary for retention out of Overseas Trade Division IV, if the liberalization strategy is undertaken;

(f) since there is no genuine need for government involvement in questions concerning trade with countries other than those that are completely centrally planned - questions which traders themselves will quickly attend to - Overseas Trade Division V becomes another candidate for abolition;

(g) as with other instances of privatization, there might be gains in terms of cost and efficiency if the record-keeping functions of the Companies Division were put out to contract, with commercial contractors (or an organization formed by the existing workforce) being subject to regular review;

(h) when the reliance on export credit subsidies is removed, the Export Credit Guarantee Department could probably be reconstituted as a purely private sector body;

(i) in accordance with the proposed approach to establish less arbitrary principles for dealing with monopolies and mergers, the



existing Commission could be replaced with a somewhat expanded Office of Fair Trading and a new version of the Restrictive Practices Court that would be the first place for hearings on all cases of the abuse of monopoly power.

The name 'Department of Competition' might be a more accurate description of the role of the official agency concerned with trade, once it had renounced its protectionist function and had begun the development of greater domestic and international freedom in exchange.

### Transparency and policy evaluation

One of the least pleasant features of current policy-making in both the United Kingdom and the European Community is that it is decided in secret and without any serious evaluation of the costs or benefits, usually in order to placate some particular pressure group. These are related problems. Secrecy helps pressure groups, as does a failure to do any serious analysis of the costs of policies. These features of policy-formation and evaluation suggest that:

(a) in both the European Community and among policymakers in the UK, there needs to be a much more substantial input from economists into basic policy formation; and

(b) requests for protection of particular industries, whether under less-than-fair-value provisions (that is dumping and subsidy cases) or provisions for safeguard protection are best examined publicly, after a thorough investigation of the costs and benefits of the proposed remedy.<sup>1</sup> All parties, including other industries and consumers, should be encouraged to submit evidence.

(c) the mercantilist use of aid is unworthy of liberal countries: aid would be better given on an untied basis, with the total adjusted to allow for the inflation of present aid by the costs of tying it to British exports. Aid by way of the export of enterprise and competitive attitudes is nevertheless likely to be more effective still.<sup>2</sup>

### THE GOAL OF REFORM

The topic of this report is only one function of the old Department of Trade, but at the same time, perhaps the most important

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1. On the importance of evaluating and publicising the costs of protection see J M Finger, 'Incorporating the Gains from Trade Into Policy', The World Economy, December 1982, pp. 367-371.

2. See the Omega Report on Foreign Policy (London: Adam Smith Institute 1983).



single objective of a liberal policy: promotion of competition. At a time when arguments are put forward for accommodation to the reality of protectionism, or when the sins of others are used to justify our own, it is essential to understand the domestic interest in more liberal trade. The task of policymakers is not made easier by blurring the case or by pragmatic adjustments to political pressure. On the contrary, such accommodation only makes it more difficult to sustain a liberal policy domestically and so make a contribution to preserving an open international economy.

Because of its membership of the European Community Britain's policy is circumscribed in many respects. At the same time, membership gives British policy global weight. By adopting a more liberal stance Britain can simultaneously improve the performance of its own economy and enhance the prospects for more enlightened thinking in the European Community. There is little credit in simply continuing the creeping protectionism of recent years, since such a course serves only to impoverish some, less organized British consumers at the expense of well-organized special interest groups. In our judgement, Britain has the strength to give up its position as being part of the problem and instead to take on a new role as a vital part of the solution.