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# Undermining the WTO: The Case Against 'Open Sectoralism'

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I S S U E S

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**SUMMARY** With challenges mounting to the World Trade Organizations agenda of broad-based multilateral trade liberalization, many U.S. trade analysts are arguing for a less ambitious approach. They extol the virtues of reducing barriers to trade along sectoral lines, citing past successes in telecommunications, financial services, and information technology. But this sector-by-sector approach to liberalizing trade (termed open sectoralism in this paper) is fraught with political and economic hazards. Open sectoralism has actually reduced political support for multisector trade negotiations that would benefit a significantly broader group of industries and consumers. Moreover, by liberalizing only highly competitive sectors, it bolsters the least efficient sectors of the economy. Ironically, at the same time that open sectoralism is the subject of unadulterated praise, protectionist sectoral measures are derided. Yet by buying off narrow and powerful protectionist interests, these arrangements have often cleared the way for comprehensive multilateral trade negotiations of the kind so clearly needed now.

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## Introduction

“...the global-round approach to trade talks, involving all WTO participants in a comprehensive agenda requiring bargains across several sectors, may have outlived its usefulness. Focused negotiations on trade issues in specific sectors among a smaller group of WTO members are a promising alternative. Such negotiations have produced significant agreements in information technology, telecommunications, and financial services.”

— Laura D’Andrea Tyson, “What Really Sabotaged the Seattle Trade Talks” *Business Week*, February 7, 2000.

The “Millennium Round” of the World Trade Organization (WTO) in Seattle, slated to be launched in November 1999, foundered badly. As of early 2001, global trade negotiations are still stalled, and many analysts are pessimistic about the WTO’s prospects. Responding to this crisis, leading analysts of U.S. trade policy such as Laura D’Andrea Tyson, the former head of the National Economic Council under President Bill Clinton, have argued that negotiating market opening on a sectoral basis—as has been the case in information technology, telecommunications, and financial services—is the logical way to proceed. They claim that the Seattle Round failed because of the WTO’s excessively broad mandate.

In contrast, we believe that reducing barriers to trade on a sectoral basis—which we term *open sectoralism*—can damage the prospects for broad scale global trade liberalization and has already had an adverse impact on the Millennium Round negotiations. Further, we argue that protectionist sectoral arrangements that raise barriers to trade historically have done much less damage to the trading system than is often believed. In fact, by buying off narrow, powerful protectionist interests, the administration has been able to proceed with broad-based multilateral trade negotiations.

Much debate has taken place over the benefits and costs of regionalism, with some analysts suggesting that regional agreements may have detrimental effects on the WTO. Likewise, protectionist sectoral arrangements have been criticized as the bane of the General Agreement on Tariffs and Trade and WTO. On the other hand, commentators have seen *open*

sectoral trade agreements almost uniformly as a boon to the cause of trade liberalism. This unadulterated praise of open sectoralism has led commentators trying to explain the Millennium Round’s aborted start to focus on factors such as the role played by labor and environmental activists in the debacle in Seattle, or the lack of leadership from the WTO Secretariat. By contrast, we argue that an important shift in U.S. trade policy thinking and strategy was equally, if not more, important in stalling the trade talks. U.S. “successes” in sectoral negotiations over the last four years that have led to the liberalization of trade in telecommunications, information technology, and financial services have been Pyrrhic, coming ultimately at the expense of the multilateral trading system.

Open sectoralism is politically and economically hazardous. From a political perspective, market opening along sectoral lines has *reduced* political support for multilateral, multisector negotiations that would benefit a significantly broader group of industries and consumers in the United States and elsewhere. By giving a few economically successful sectors the trade liberalization that they demand, the administration has undermined the broad coalition for free trade. Moreover, from an economic perspective, such agreements may also *reduce* economic efficiency. Put simply, by liberalizing only specific, highly competitive sectors, open sectoral trade agreements may lead to a perverse incentive to invest in or discourage exit from the least efficient areas of the economy.

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## The Advent of Sectoralism in Trade

In recent years, the United States has pursued a policy of using sectoral negotiations to open markets. Indeed, such negotiations have been the preferred U.S. approach since the Uruguay Round, which lasted from 1986 to 1993 and which led to the creation of the WTO as a successor organization to the General Agreement on Tariffs and Trade (GATT).

Sectoralism has a much longer history, however, emerging in the early days of the GATT in the 1950s. In their earlier incarnation, sectoral trade agreements responded to domestic protectionist pressures by closing markets. The first such market-restricting arrangements were in textiles, steel, electronics, autos,

***Recent U.S. successes in trade liberalization have been Pyrrhic***

footwear, and semiconductors. The creation of the euphemistically labeled Voluntary Export Restraints (VERs) were supposed to be *temporary* sectoral responses to evade the strictures of Article 19 of the GATT that prevent importing countries from taking discriminatory protectionist action against trading partners. These arrangements typically started out as bilateral, government-to-government, sector-specific measures in mature, low-value-added, and labor-intensive industries such as textiles, apparel, and footwear. More recent sectoral efforts shifted away from these classic protectionist arrangements that closed markets, to the current trend in promoting sector-by-sector liberalization.

This recent trend began with the “zero-for-zero” tariff negotiations in the Uruguay Round. Agreement was reached on the dismantling of tariff barriers in 10 sectors. Subsequently, pushed by American firms, the U.S. government negotiated sectoral agreements in telecommunications, information technology, and financial services. The first such major effort, the Information Technology Agreement (ITA) was developed in 1996, with the strong support of the APEC (Asia Pacific Economic Cooperation) forum. A successor to the highly contentious semiconductor trade arrangement between the United States and Japan, the ITA eliminates all tariffs on semiconductors, computers, computer equipment, integrated circuits, telecommunications equipment, and related manufactured goods. Building on the momentum generated by the successful conclusion of the Uruguay Round, the United States was able to push through the ITA agreement in a highly expeditious manner. Covering over 90 percent of the total trade in information technology (IT) products, the ITA took effect in April 1997 and forms the foundation upon which WTO members are currently considering further liberalization of the IT sector.

The ITA approach has since been championed as a model for other sectors. For example, a second sectoral arrangement, the Global Agreement on Basic Telecommunications, was negotiated in 1997. In effect since 1998, it covers over 95 percent of trade in telecoms. Following closely on its heels, the December 1997 Financial Services Agreement (FSA) to liberalize trade in banking, insurance, and securities

took effect in April 1999, and covers over 95 percent of trade in these services. Commenting on the success of these agreements in a speech on June 5, 2000, then-Ambassador Charlene Barshefsky, the U.S. Trade Representative, noted that “A careful, coherent, and sustained trade policy in the information industries...is at the heart of the open, equitable and progressive networked economy...” She went on to say that, “This in turn will do more than almost any initiative to reach the goals at the heart of trade policy: broadening opportunity, sparking technological progress, raising living standards and reducing poverty.” As Barshefsky noted in an October 23, 2000, speech: “We are now seeking consensus on expanding this agreement—“ITA II” to include more products...” Thus, current U.S. policy is now focused on expanding existing agreements such as the ITA, rather than on a broader-based set of negotiating objectives. While well-meaning, this view ignores the politics and economics of sectoralism.

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### **The Politics of Protectionist Sectoral Trade Agreements**

In the past, sectoral agreements raised trade barriers. Many analysts claimed that efforts to restrict trade on a sectoral basis would take the world down the same path as the elaborate protectionist arrangements in textiles developed in the 1950s. As economists fond of the bicycle theory put it, “You have to keep moving forward if you don’t want to fall over.” Protection in textiles and apparel in the early 1960s did eventually expand to the wool and man-made fiber textile and apparel industry in the early 1970s. However, in other sectors, the dire predictions of doomsayers did not come true. Indeed, many protectionist sectoral arrangements have been dismantled. For example, the United States negotiated a VER with Japan for color televisions in 1977, which expired in three years, and others for color televisions with Korea and Taiwan in 1980, which expired within two years. In footwear, VERs with Taiwan and Korea in 1977 were allowed to lapse in 1981. And in autos, the 1981 agreement to restrict Japanese cars was essentially inoperative by the late 1980s as the administration raised the quota continually until it was finally

*The first sectoral agreements closed markets; today’s more often open them*

*Without protection, the textile/apparel coalition would have blocked overall liberalization in the 1960s*

removed in 1994. Even quotas in the worst example of sectoral market closing—textiles and apparel—are slated to be phased out by 2005.

These positive experiences do not imply that sectoral protection has no costs or should be encouraged. Rather, the point is that by providing the politically sensitive textile and apparel industry with protection in the 1960s, the United States was able to press forward with the Kennedy Round, the most significant multisectoral market-opening effort of the time. From a politically realistic perspective, rather than one based on pure idealism, moderate protection for textiles was the price that had to be paid for the greater good of comprehensive liberalization. Without it, the powerful textile and apparel coalition would have blocked any overall liberalization efforts—just as they managed to kill off the American effort to institutionalize the GATT into the Organization for Trade Cooperation in the 1950s.

#### **The Politics of Open Sectoral Trade Agreements**

Open sectoralism, like APEC's open regionalism,<sup>i</sup> looks particularly attractive at first glance. The ITA, the Basic Telecom agreement, and the FSA have all gone beyond the removal of tariffs to eliminate non-tariff barriers. According to conventional wisdom, these are examples of forward movement in trade opening that should be encouraged and expanded.

From a political standpoint, however, open sectoralism looks less benign. Those sectoral interests that were the most ardent proponents of liberalization in the Uruguay Round—information technology, financial services, telecommunications—now have their own sector-specific arrangements. Whereas the proliberalization efforts of these groups in the Uruguay Round facilitated important tradeoffs among various sectors, helping to broaden participation and the coverage of a wide range of issues, their principal interest has now shifted to expanding their own sectoral arrangements rather than supporting the wider trade liberalization agenda.

Although one might argue that open sectoral accords are being negotiated under the auspices of the built-in agenda of the Uruguay Round—and thus

are based on a consensus among members—the continued effort by the United States to focus only on services and agriculture, and the desire of some countries to limit negotiations to only some areas, is politically detrimental. The principal reason is that it narrows the opportunity for tradeoffs among sectors. Moreover, there are a host of issues in manufactures and other aspects of the WTO, such as dispute settlement and anti-dumping, which many countries are keen to address but a sectoral approach would ignore.

Other commentators suggest that since agreements that apply to only a subset of members of the global trading system are not unprecedented, the current emphasis given to open sectoralism should not cause alarm. Earlier examples of subset agreements include the government procurement and subsidies codes of the Tokyo Round of GATT; both applied only to a small set of signatories. These agreements, however, were not on a sector-specific basis. Even though these agreements did generate a damaging multi-tier membership in the GATT, they did not directly create vested interests on a sector-specific basis. Thus, in these instances, the multisectoral coalition to liberalize trade remained in place.

Some major trading partners of the United States—in particular, the Japanese—believe that the lukewarm support of the American business community for a new round of WTO negotiations can be traced to the “success” (from an American perspective) of earlier sectoral agreements. For this reason, these trading partners have opposed the negotiation of a second Information Technology Agreement, believing that such an agreement would weaken the interest of key sectors of American business in negotiating a broader trade liberalization agreement.

The pursuit of open sectoralism in APEC illustrates some of the problems with this approach to trade liberalization. Following the successful conclusion of the ITA, the United States pressed for further negotiations within APEC for accelerated liberalization on a sectoral basis as a means of reviving APEC's stalled trade agenda.

APEC member economies subsequently proposed various sectors for liberalization. Not surprisingly, they focused on areas in which their domestic producers

enjoyed a competitive advantage. At their meeting in Vancouver in 1997, APEC leaders—in an effort to construct a package deal from which all economies would benefit—selected for early liberalization only 15 out of hundreds of possible sectors. Much to the embarrassment of the grouping, the package fell apart. The ostensible reason was the refusal of the Japanese government to agree to liberalization in forestry and fisheries (although other Asian governments were undoubtedly happy to hide behind the Japanese veto). The costs of liberalization in politically sensitive sectors were more than the Japanese government was willing to bear. In an effort to save face, APEC referred the program to the WTO, where it has since effectively been buried.

APEC's experience with sectoral liberalization demonstrates the political difficulties of constructing a package that will satisfy all participating governments when negotiations are conducted in only a limited number of sectors. In such circumstances, domestic protectionist interests are mobilized. Without a comprehensive approach to trade negotiations, the political influence of these protectionist forces cannot easily be offset by groups with a strong interest in the liberalization of other sectors. And if such protectionist forces triumphed in sectoral negotiations in the APEC context—where the commitments of governments are “voluntary” and “indicative”—they are likely to be even more forceful in WTO negotiations that culminate in legally binding commitments.

Whatever the possible merits of open sectoral agreements, their negotiation will not be easy in any case. The negotiations for the ITA were successful for reasons unique to that sector. Information technology is truly a multiproduct sector: it ranges from memory chips to cordless phones, from automatic teller machines to software. It is also the most globalized of sectors, with producers from different countries linked in production networks that frequently span different continents. Many economies had substantial two-way trade in information technology products and thus a stake in the liberalization of access to trading partners' markets.

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### The Economics of Open Sectoralism

Open sectoralism is also problematic from an economic perspective. Governments have negotiated such agreements in the past in sectors where tariffs were already low. This follows an obvious political rationale: producers that enjoy high levels of protection are usually uncompetitive and dependent on the tariffs for their survival. Governments rarely have the political will to confront these producers, particularly in the absence of a package that will bring assured benefits to other sectors of the economy. Accordingly, sectoral trade agreements typically have exempted sectors that governments regard as sensitive. In the electronics field, for example, the United States has refused to include consumer electronics within the ITA.

In their zeal to promote any type of trade liberalization, many economists have forgotten a basic macroeconomic lesson. Put simply, when tariff cuts or the removal of other trade or nontariff barriers are concentrated in areas that have few impediments in the first place, but protection is maintained elsewhere, the result is to *increase* distortions in the domestic economy. Resources will move to or be maintained in the protected (and inefficient) segments resulting in a loss in allocative efficiency. For instance, econometric studies indicate that APEC's sectoral liberalization proposals would have caused economic losses in several APEC economies by exacerbating the misallocation of resources. Liberalization proposals in a number of sectors concentrated on products that were inputs for downstream users, which would continue to enjoy high levels of protection. In China, for instance, a reduction in protection for the chemical industry, leading to lower-priced inputs for heavily protected downstream users, would have encouraged an expansion of production in the textiles, clothing, and toys sectors.<sup>11</sup> Similarly, in the foodstuffs sector, a loss in allocative efficiency was projected for several APEC economies, including Malaysia, Japan, and New Zealand, as resources were shifted from partially liberalized products into more heavily protected food sectors.

*In multisector negotiations, the political influence of domestic protectionist forces can be offset by forces in favor of liberalization*

*We must return to multisector, multiproduct negotiations and the tradeoffs that such discussion entails*

**Conclusion: The Path Ahead**

The conventional wisdom that any liberalization is good and that all restrictions are bad is wrong. Liberalization of some sectors and not others undermines broader, more inclusive efforts, while temporary protection of some sectors can be worthwhile if it allows broad scale liberalization elsewhere. However well meaning the proponents of sectoral approaches to liberalization may be, we should not be lulled into

a false sense of security that open sectoral agreements will provide the path to free trade in the new millennium. If we wish to promote widespread trade liberalization and efficient resource allocation, we must return to multisector, multiproduct negotiations, and to the tradeoffs that such discussions entail. This is the task facing governments in reviving the Millennium Round. This agenda, rather than promoting an open sectoral approach, should be the top priority of negotiators.

**Notes**

<sup>i</sup> "Open regionalism" calls for the provision of market access to outsiders on the same terms as APEC members.

<sup>ii</sup> Dec, P., A. Hardin, and M. Schuele. *APEC Early Voluntary Sectoral Liberalisation*. Canberra: AusInfo, 1998.

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