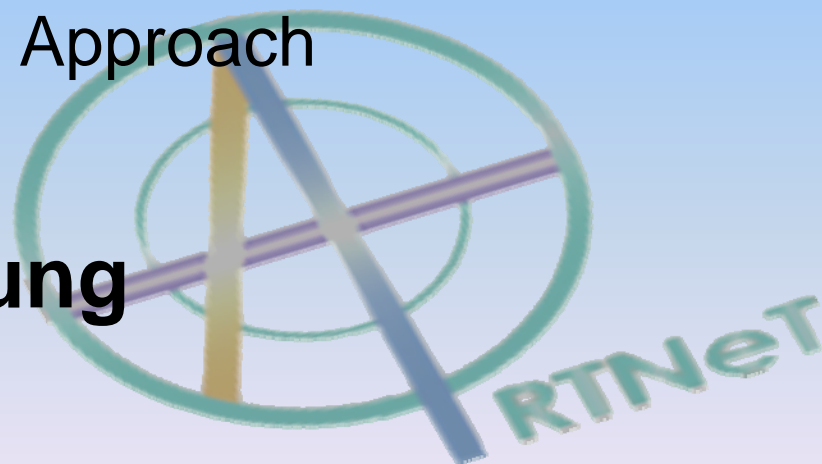


Trade-led Growth in Times of Crisis  
Asia-Pacific Trade Economists' Conference  
2-3 November 2009, Bangkok

## Session 4

Developing Countries and the World Trade Organization:  
A Foreign Influence Approach

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Asia-Pacific Research and Training Network on Trade

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# *Developing Countries and the World Trade Organization: A Foreign Influence Approach*

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- *As Doha Round trade talks floundered, there have been increasing criticisms of the behavior of the rich and powerful countries during the numerous series of negotiations.*
- *Several influential countries were accused of trying to manipulate other weaker contracting parties to go along with their proposals.*
- *According to **ActionAid**, "Threats, deception and manipulation are the underhand negotiation tactics used by rich countries such as the EU and US in the current round of global trade talks" (ActionAid 2006).*



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- *There are also increasing concerns by some developing countries that due to the asymmetric economic, political and diplomatic powers between the powerful parties and the relatively powerless members, the world trading system as coordinated and implemented by the World Trade Organization (WTO) is fundamentally unfair.*
- *"The problem is that the world trade is unfair, and the WTO rules are part of the problem."  
(Duncan Cameron, Progressive Economics Forum 2007).*



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- *"In short, appealing as the idea of some kind of multilateral trade system might be in principle, it seems clear that the WTO as it currently operates does not constitute such a system. Far from setting fair trade rules to protect the interests of the weak, the WTO has been complicit in reinforcing the interests of the strong: Anarchy – the threat (real or supposed) used to justify the WTO – may be bad for the weak, but the tyranny of the strong may be worse." (Pp. 302-304, Jawra and Kwa 2003) .*



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- *The aim of this paper is to provide an analytical examination of this line of criticism.*
- *We will utilize a formal model with the following features: in both the powerful and the weak economies, pressure groups lobby to influence their trade policies in their respective countries. We then allow the powerful country the exclusive ability to spend resources to facilitate the lobbying of one of the pressure groups in the weak country, thereby moving the trade policy of the developing country in favor of the powerful trading partner. This feature of asymmetric foreign influence defines the difference between the "powerful" and the 'weak" in our model.*



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- *Our analytical approach is essentially a hybrid model combining a variant of the Grossman-Helpman protection-for-sale framework (1994) and the more recent foreign influence approach by Antras and Miquel (2008).*
- *Our paper differs from both sets of literature since in the literature related to the Grossman-Helpman framework, there is generally no modeling of foreign influence, while in Antras and Miquel (2008), there are probabilistic voters but no pressure groups. As mentioned before, we want to take the criticisms of the WTO seriously and utilize the asymmetric foreign influence feature to analytically portrait the difference between the rich, powerful country and the weak, developing economy.*



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- *One conclusion that comes out of our examination is that the strong (developed) country will always have an incentive to try to "manipulate" the weak (developing) country. But precisely because the strong will always want to expend resources to "exploit" the weak that it is in the interest of the developing countries to constrain the powerful members with principles of nondiscrimination (such as the most-favored-nation principle) as embodied by the WTO.*





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- *The contributions of this paper will be twofold: one, we extend the theoretical literature on the WTO by providing a model that features both lobby groups as well as foreign influences.*
- *Second, we use an appropriate and well-accepted formal framework and derive from the model certain conclusions that are quite compatible with the mainstream view that the WTO/GATT trading system is designed not to exploit the weak members, but instead to protect them.*



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- We have two countries, one rich and powerful and the other one is developing and weak. The basic model will be a variant of the lobbying model as in Grossman and Helpman (1994) and Fung, Lin and Chang (2007).
- However, on top of the lobbying model is the idea that the powerful country can expend resources to influence the policies of the weak countries. In Antras and Miquel (2008), the model of foreign influence is focused on a probabilistic voter model with electoral competition. Here we use a model without explicitly focusing on elections



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- The profit function of the exporting firm from the rich country and the profit function for the import-competing firm in the developing country are given by:
- $\Pi^*x^*(x^*, x, \tau) = x^*P_X(x + x^*) - c^*x^*(w^*, x^*) - \tau x$
- $\Pi_X(x^*, x) = xP_X(x + x^*) - c_X(w, x)$



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- The import-competing firm in the rich economy produces good  $y^*$  and competes with the export  $y$  from the developing economy, with the respective profit functions being:
- $\Pi^*_{y^*}(y^*, y) = y^*P_y(y + y^*) - c^*_{y^*}(w^*, y^*)$
- $\Pi_y(y^*, y) = yP_y(y + y^*) - c_y(w, y) - \tau^*y$

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- The indirect utility functions of each individual in groups  $i^*$  and  $i$  have the forms:
- $$\psi^{*i^*} = I^{*i^*} + u^*(Y^{*c*i^*}) - P_y Y^{*c*i^*} = I_i + \zeta^*(P_y)$$
- $$\psi_i = I_i + u(Y_{ci}) - P_y Y_{ci} = I_i + \zeta(P_x)$$

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- $\psi^*x^* = \Pi^*x^*/a^*x^* + (\tau^*y)/(\alpha^*x^* + \alpha^*y^*) + \zeta^*$
- $\psi^*y^* = \Pi^*y^*/a^*y^* + (\tau^*x)/(\alpha^*x^* + \alpha^*y^*) + \zeta^*$
- $\psi^*m^* = I^*m^*/a^*m^* + \zeta^*$
- $\psi x = \Pi x / \alpha x + (\tau x^*) / (\alpha x + \alpha y) + \zeta$
- $\psi y = \Pi y / \alpha y + (\tau x^*) / (\alpha x + \alpha y) + \zeta$
- $\psi m = I m / \alpha m + \zeta$

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- *With no pressure group activities the governments choose the appropriate levels of  $\tau$  and  $\tau^*$  to maximize social welfares:*
- *$Max_{\tau^*} \psi^* G^* = a^* x^* \psi^* x^* + a^* y^* \psi^* y^* + a^* m^* \psi^* m$*
- *$Max_{\tau} \psi G = a x \psi x + a y \psi y + a m \psi m$*

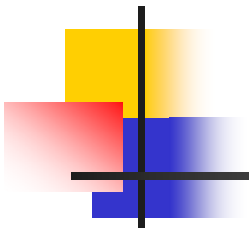


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- In equilibrium, the contribution schedules of each pressure group in each country are given by:
- $\alpha^{*i*} \psi^{*i*} \tau^{*} = \eta^{*i*} \tau^{*} (\tau^{*}) / \varepsilon^{i*}$
- $\alpha^i \psi^i \tau = \eta^i \tau (\tau) / \varepsilon^i$



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- $Max \tau^* \Omega^* = \gamma^* [\eta^* x^* (\tau^*) + \eta^* y^* (\tau^*)] + \psi^* G^*$
  - $Max \tau \Omega = \gamma [\eta x (\tau) + \eta y (\tau)] + \psi G$
  - $[1 + \gamma^* \varepsilon x^*](a^* x^* \psi^* x^* \tau^*) + [1 + \gamma^* \varepsilon y^*](a^* y^* \psi^* y^* \tau^*) + a^* m^* \psi^* m^* \tau^* = 0$
  - $[1 + \gamma \varepsilon x](a x \psi x \tau) + [1 + \gamma \varepsilon y](a y \psi y \tau) + a m \psi m \tau^* = 0$



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- *We now assume that these two countries have asymmetric power. The rich, powerful country is able to help finance lobbyists or pressure group operating in the developing economy, while the poor country is too weak to influence the powerful member.*
- *For the rich country, we now assume that it can expend resources to reduce the organization costs of one of the lobby groups.*
- *The objective function becomes:*
- $$\Omega I^* = \gamma^* [\eta^* x^* (\tau^*) + \eta^* y^* (\tau^*)] + \psi^* G^* - \frac{1}{2}(\epsilon x / \sigma)^2$$



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- In addition to choosing its own tariff, the powerful country chooses  $\varepsilon_X$  so that:
- $$\psi^* G^* \varepsilon_X - \varepsilon_X / \sigma^2 = 0$$
- This reduces to:
- $$\mathcal{L}^* X^* \tau [\partial \tau / \partial \varepsilon_X] - \varepsilon_X / \sigma^2 = 0$$



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- *Suppose we consider the case where  $\sigma$  is very large so that the rich country is extremely powerful. It can easily be shown that with a sufficiently large  $\sigma$ , the foreign-influenced tariff ( $\tau_I$ ) and the foreign - influenced national welfare ( $\psi_I$ ) of the weak economy will have the following characteristics:  $\tau_I < \tau_G < \tau_P$ , and  $\psi_I < \psi_G < \psi_P$ . In other words, under strong foreign influence, tariff level will be smaller than the optimal level and national welfare will also be smaller than the optimal level.*



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- *How would the results be different with MFN? Since the concessions of market access will have to be shared by all other members of the WTO, the marginal benefits of using resources to manipulate the weak country will be reduced. In other words, this leads to a larger  $\tau I$ . Since without the MFN, we are in the range of tariffs between free trade and the optimal tariff, smaller concessions of market access leads to an improvement of national welfare for the developing country*



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- *Proposition 1. The rich, powerful country that is self-interested will always have an incentive to exert influence on the weak, developing economy, with or without the WTO. Without the principle of MFN, the rich country will influence the developing country to open up its market even more than under MFN.*
- *Proposition 2. The weak, developing country is better off under MFN if the rich country is sufficiently powerful*



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- *How would the analysis be different if the countries operate within the WTO norm of reciprocity? If we impose reciprocity, concessions of market openings by the developing country should be matched by a reduction of tariffs in the powerful country, leading to an erosion of profits of the import-competing firm in the rich economy. The choice of the extent of influence will be implicitly defined by the revised first order condition, taking into account reciprocity:*
- $\Pi^* \chi^* \tau [\partial \tau / \partial \varepsilon x] - \varepsilon x / \sigma^2 - \Pi^* \gamma^* \tau^* [\partial \tau^* / \partial \tau] [\partial \tau / \partial \varepsilon x] = 0$



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- *Proposition 3. With reciprocity, the weak, developing country will be less influenced to give market access concessions. With a sufficiently powerful rich country, the developing country is better off with reciprocity*





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- *We show in this framework that the strong country will always have an incentive to exert influence on the weak, developing country. This will indeed, as the critics of the WTO contend, lead to more market concessions and a lowering of profits of the import-competing firm in the poor country.*
- *However, contrary to the arguments of the critics, we show that in the presence of foreign influences, the WTO with its principles of MFN and reciprocity will actually reduce market opening concessions and increase national welfare of the developing country.*