

# Issues Surrounding Liberalized Trade

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As I write this, I have not yet seen Phil Seng's paper. Therefore, I don't know whether it will confirm my strongly held hypothesis that, at least among developed countries, trade in meat is highly restricted. Both Canada and the U.S. have meat import laws which impose import quotas. Many countries use temporary and/or ongoing non-tariff barriers in the form of health and sanitary restrictions. Both Europe and Japan have long used a combination of tariff barriers, import quotas and non-tariff barriers to protect their markets. Finally, trade in meat products is increasingly affected by alleged subsidies and the countervailing reactions to those subsidies.

Given the current situation, there can be no doubt that further liberalization of trade in meat would have major implications for trade flows and the location of production in the world. Most people on this continent would argue that North America would be the major beneficiary of a more liberalized trading environment. This writer is not yet convinced.

Obviously, the two vehicles for liberalized trade are the Canada-U.S. Free Trade Agreement (FTA) and the ongoing GATT negotiations. The issues in both be parallel and they are the subject of this paper. The objectives are as follows. The first is to describe the elements of the FTA that will affect the meat sector. The second is to discuss the implications of the FTA on trade within North America. The third objective is to describe the major issues in the GATT negotiations that relate to trade in meat.

Finally, we will come back to the question posed above, regarding whether liberalized world trade would benefit the North American meat sector.

## The Free Trade Agreement

The Free Trade Agreement between Canada and the United States has four major elements in it that may affect North American trade patterns in meat.

Before discussing each of those elements, it should be noted that the FTA is a bilateral treaty between the two countries. It has been ratified through the legislative processes in both countries, as is any other treaty. Its legal status under international law emanates, at least in part, directly from the GATT agreements. The important elements follow below.

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## Tariff Reduction

Probably the most concrete and clearly understood component of the FTA is the agreement to reduce tariffs in equal increments over the next five or ten years on most products. In the livestock and meat sector, this part of the agreement will probably not have much impact for the following reasons. First, the scheduled tariffs on livestock and fresh meat of both countries are relatively minor, at about one cent per pound. Phasing out a minor tariff will clearly have little effect on trade. The more important tariff that exists currently is the countervailing duty levied by the United States on Canadian exports of live hogs. This duty emanates from Canada's alleged "unfair" subsidies and is not to be reduced under the agreement.

Both countries levy higher duties on processed meat products. As these duties are eliminated, there may be some impact on trade. However, I expect it to be quite minor.

## Market Access

The FTA has three market access components that will affect the meat sector. The most obvious is the fact that each country has pledged to exempt the other from its meat import law. The U.S. has had a meat import law since at least the early 1960's. Under this law, the President may impose import quotas whenever total imports begin to approach a certain target level. The apparent objective of this law is to protect the American market from low-priced imports from Australia, New Zealand and Argentina. It has, however, also been used against Canada because Canada has been seen as a back door for the entry of Oceanic beef into the United States. In the late 1970's, Canada passed a companion law. It has not been used to date, nor has the U.S. meat import law been used since Canada's was passed. The threat of trade sanctions, however, under the meat import law is always in existence.

Exemption from each other's meat import laws will likely be a benefit for Canada. The existence of the U.S. meat import law has likely caused Canadian meat packers to be reluctant to invest sufficiently in plant and capital equipment to achieve economies of scale, economies that could only be realized if a significant portion of a plant's output is exported. Rational businessmen would not take the risk of investing in this manner and then having the plant's market cut by a political decision. Removing the source of the political decision should give Canadian investors more confidence and, therefore, the incentive to move toward more world-scale plants. One would surmise that this is the rationale for investment in a large plant in Alberta which is due to open soon.

The second market-access provision that will affect the livestock sector is Canada's pledge to remove import certificates for wheat, oats and barley when it is adjudged that government support to grain producers is the same in both

countries. Import certificates for grains have been a major source of protection for the Canadian grain sector. Until now, the Canadian Wheat Board has been empowered to issue import certificates for these three commodities. As a matter of practice, the Canadian Wheat Board almost never does. Therefore, the certificates have, in essence, been an import quota equal to zero.

The demise of Canada's import certificates will have obvious effects on the grain sector. However, its effects on the livestock sector are rather more subtle. It is demonstrable that feedgrain prices in Western Canada are more variable than anywhere else in the two countries. This is largely due to the institutional nature of the grain market in Western Canada and the fact that the market cannot arbitrage with the United States. By removing the import quotas and, therefore, ensuring that feedgrain prices in Western Canada must stay in line with those in the United States, variations in feedgrain prices will be reduced. By reducing the variation in feedgrain prices in Western Canada, farmers in that region will have more incentive to invest in livestock, especially beef production.

Putting the two elements of market access together means that Canadian farmers will have more incentive to invest in the production of cattle, while Canadian packers will have more incentive to invest in processing facilities. All other things equal, I would expect this to mean that North American trade patterns would change somewhat as more cattle and beef are produced in Western Canada, likely for consumption in that region as well as in the U.S.-Pacific coast areas. On the other hand, I would also expect to see an increase in the exports of beef from the U.S. Midwest into Eastern Canada as a result of these two things.

The third market-access provision has to do with poultry. In Canada, our poultry sector is regulated by producer-controlled marketing boards. These boards have the authority to control supply and establish prices at the first-buyer level of the market. Under article 11 of the GATT agreement, Canada can also impose import quotas because of the national supply management programs. When our national supply management programs began in the 1960's and 1970's for poultry products, Canada's import quotas were established based on the percentage share of the market U.S. product had of each of the three poultry products during the previous five years. For example, for broilers, this quota was set at 5.7% of domestic consumption. In addition to the global import quota, Canada also allows supplementary imports whenever it can be shown that there are local shortages. With the price differences that have sometimes existed between the two countries, it is usually not difficult to demonstrate local shortages. Therefore, supplementary imports have become a mainstay in the market.

Under the FTA, the global import quotas were adjusted to reflect the average of the supplementary imports during the three years before the agreement was signed. This is most significant for chicken, where the global quota has increased from 5.7% to 7.5% of domestic consumption.

The increase in import quotas, the retention of supplementary quotas, the reduction in tariffs, and some interesting things that have been done with respect to definition of some product classes mean that the U.S. will enjoy a slightly larger

share of the Canadian market but, as the same time, the marketing boards in Canada, as well as the processors in Canada, have retained a substantial amount of protection.

### Harmonization of Standards

Standards have to do with everything from grades to health inspection to labelling and package sizes. The FTA contains two general pledges. The first is that neither the U.S. nor Canada will use standards as non-tariff barriers against the other country. This simply means that, if standards in the countries are different but accomplish the same objective, then neither country will stop product from entering. The second part of the agreement is that, where possible, the two countries will try to harmonize standards.

There are potentially a large number of areas of harmonization that can affect trade in meat. These include:

- (a) drugs and hormones used in the production of animals;
- (b) grades of animals or meat;
- (c) plant sanitation and health inspection procedures; and
- (d) packaging and labelling regulations.

Final agreement on these areas has not yet been reached. Working parties have been appointed by the two governments and are presumably moving toward final agreements. My contacts in the meat trade indicate to me that the progress so far has been quite interesting. Initially, even before the FTA was ratified, there was a new spirit of cooperation on meat inspection procedures. Procedures were becoming streamlined and it was increasingly easy to move product across the border from Canada to the United States. Subsequently, there have been complaints on both sides of the border about proposed procedures that would result in each country trusting the judgment of meat inspectors in the other. Perhaps as a result of these complaints or because of the less friendly atmosphere that now exists because of the current trade dispute on pork, our people on this side of the border are finding it increasingly difficult to move product into the United States. I have not checked with people in the U.S. about whether the opposite is also the case.

### Dispute Settlement

The so-called agreement in the FTA on dispute settlement is the least developed and will be the most contentious issue as we go through time. Canada desparately wanted relief from the U.S. dispute settlement's mechanism. What we agreed to is: a bi-national panel will replace judicial review of appeals (which may be unconstitutional in the United States); each country pledged to exempt the other from future punitive changes in trade laws; and to negotiate a new dispute settlement mechanism over the next five or seven years. The latter is the most important, but clearly the least developed of these three elements.

To explain Canada's concern with the U.S. dispute settlement mechanism, it is necessary to follow two threads of logic where agriculture is concerned. The first has to do with the nature of agricultural policy in the two countries. U.S. farm policy has historically followed a path that economists would call the "large country" policy. In international trade

theory, the large country is the one whose actions have major impact on the market. In the current discussion, this means that U.S. farm policy has relied on instruments that would remove resources from agricultural production and/or remove product from the market through government intervention. When I was in U.S. universities and we learned about U.S. policies in undergraduate and graduate courses, they were invariably explained in diagrams that assume the U.S. is the only market of relevance; i.e. that the U.S. is a "closed economy." This implies that U.S. policy has tended to assume the U.S. is so important that it dominates the rest of the world's market.

Canada, being a small country, has seldom pretended that actions within its own borders have much effect on the world market. It would be incongruous and ridiculous in the extreme if, for example, Canada removed enough acreage to reduce its 200 million bushel corn crop by 25% when there is a seven billion bushel one just south of us. We would not likely have much effect on world prices.

On the other hand, there is a presumption in Canada that it is socially desirable to cushion farmers against the extremes of market vagaries. In fact, one of the vagaries against which many Canadians feel that livestock producers should be protected is changes in U.S. grain policy. If society has such a goal and we are a small country whose actions in the market place have little effect on the market, then it makes no sense to have policies that are similar to U.S. policy. It makes far more sense to use transfers from the treasury to support or stabilize farm prices or incomes. Incidentally, this is the case for most countries.

This fundamental difference in agricultural policy creates the first part of the problem we have with the dispute settlement mechanism. Since the U.S. does not rely heavily on direct subsidies as instruments of stabilization policy while Canada and other countries do, it is not surprising that the U.S. might interpret domestic subsidies in other countries as practices that give an unfair advantage in trade. It is also not surprising that inhabitants of the other countries might interpret U.S. actions to end such subsidies as an attack on their sovereignty.

The second element of the problem with the dispute settlement mechanism has to do with U.S. law, process and/or precedent regarding the implementation of countervailing duty actions. According to the GATT subsidies code, when one country wants to bring a countervailing duty action against another, three things have to be proven. First, it must be proven that the exporting country has subsidies and the level of subsidy must be measured. Second, it must be proven that exports are increased as a result of the subsidy. Finally, it must be proven that the exports that are caused by the subsidy result in material injury to producers in the importing country.

The subsidies code is very clear that exports caused by the subsidies must be separated from exports caused by other factors. This is clearly indicated in the following quote from Art. VI (4) of the GATT subsidies code:

It must be demonstrated that the subsidized imports are, through the effects of the subsidy, causing injury within the meaning of this Agreement. There may be other factors which are at

the same time injuring the industry, and the injuries caused by these other factors must not be attributed to the subsidized imports.<sup>1</sup>

If all these things can be proven, then it is legal under the GATT for the importing country to impose a duty equal to the amount of the subsidy in the exporting country. It is from this equality that the notion of a countervailing duty arises.

Our problem with the U.S. dispute settlement mechanism is that it fails to take into account the whole issue of causality between the subsidy and exports. To win a countervailing duty case in the United States, one merely needs to prove that the exporting country has subsidies, that it has exports and that the exports cause material injury to domestic producers. The question is never asked whether the same level of exports would occur in the absence of the subsidies or, if not, what level of exports would. Since the pork case was first brought by the United States against Canada in 1984, it has always been presumed by the plaintiffs and, by extension, the U.S. International Trade Commission, that all exports from Canada to the United States are caused by our subsidies. Most recently, I have read testimony by Mr. Glen Grimes, the expert for U.S. plaintiffs, in front of a committee of the U.S. Congress that, once again, trots out an analysis which tries to show the effect of Canadian exports of pork and hogs on U.S. hog prices. Nowhere does it ever indicate what portion of the Canadian exports are caused by the Canadian subsidy. In our view, as a signatory to the GATT, one should only be concerned by economic injury that flows from subsidized exports.

For both of the foregoing reasons, the United States is the world's leading countervailer. By 1985, all 95 signatories to the GATT had brought a total of 210 countervailing duty actions against other members. Of these 210 actions, 192 were brought by the United States. Since 1985, my rough tally would indicate that the ratio has not changed.

A forthcoming paper in the *Journal of Canadian Public Policy*<sup>2</sup> by Erna van Duren and me goes into the problem and its economic solution in some detail. However, suffice to say at this point, we in Canada are not impressed with the current situation with respect to dispute settlement. At this point, the only hope we have for the future is that, during the next five or seven years, we can come up with a better dispute settlement mechanism. Meanwhile, we certainly have not agreed on what is a trade-distorting and, therefore, countervailable subsidy. We are still faced with the same procedures and precedent as before and, given that we are paying a countervailing duty on our live hog exports, are facing a countervailing duty action on exports of fresh and frozen pork, and are being threatened with a countervailing duty action on exports of beef, this is going to be a very sore point, for the foreseeable future, in the livestock and meat sector. Moreover, the problem has very wide implications. Most entrepreneurs are not wildly enthusiastic about the prospects of investing in an

<sup>1</sup>Subsidies and Countervailing Duties Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, 1979, Article VI(4).

<sup>2</sup>van Duren, Erna and Larry Martin, "The Role of Economic Analysis in Countervailing Duty Disputes: Cases Involving Agriculture," *Canadian Public Policy*, 1989 (forthcoming).

industry that can face these types of action with little possibility of winning.

### The GATT Negotiations

In many ways, the issues surrounding liberalized trade and the GATT negotiations are very similar to the issues in the Canada-U.S. Free Trade Agreement. They fall in exactly the same categories but, as will be clear below, the categories need to be reorganized a bit.

### Subsidies

If one is aware about anything at all in the current round of the GATT negotiations, it is that this round is focused on agriculture and that attempts are being made to devise a method of putting some discipline into the use of agricultural subsidies. The issue has several very closely intertwined elements.

Most fundamental to the entire debate is to define a trade-distorting subsidy. This is reasonably easy in the case of an export subsidy, but very difficult when domestic farm programs come into play. Not only is it difficult to draw the line at what a trade-distorting subsidy is; but, quite clearly, the whole matter is tied up in questions of political sovereignty when domestic agricultural policy is questioned. There can be no more thorny issue than the domestic agricultural policy of the European Community. EEC policy has unquestionably resulted in a higher level of production for most commodities, particularly grain commodities, than would have been the case in Europe without the policy. It is impossible to argue that European subsidies and/or other policy instruments have not been trade distorting. It is also difficult to argue with the Europeans that their policy is both an economic and a social policy and that it has been successful in meeting its social objectives. It is, finally, difficult to understand why any European politician would ever have been in favour of dismantling a program, the benefits of which have been capitalized into land values. Politicians who do things to take away wealth from their constituents seldom keep their constituencies for very long.

A logical outcome from discussions about trade-distorting subsidies then becomes the issue of "decoupling" government transfers from production levels. It is argued that if providing income or price supports to farmers is a worthy goal of society, then the best way to achieve that goal is through policy instruments that do not encourage production of a particular commodity or affect the level of production. This has sparked interest in income stabilization programs that attack income instead of the components of income, i.e. the returns from individual commodities. While these so-called decoupled programs have intuitive appeal, in my view they have two problems with regard to the current round of negotiations. First, it is hardly likely that anyone is going to come up with totally different instruments before the negotiations are supposed to be completed in 1990. Secondly, it may be difficult for ministers of agriculture to convince cabinets that they should have several billion dollars of money available to them that will have absolutely no impact on anyone's decision to do anything!

A third issue in the discussion about subsidies has to do with measurement. We have spent much time looking for an

aggregate measure of subsidies (AMS). Most people argue that any AMS should be capable of measuring the total amount of subsidy available for a commodity or country and, at the same time, separate the income-transfer effects of a subsidy from its trade-distorting effects. The most popular measure has been the producer or consumer subsidy equivalent (PSE or CSE). PSE's have received wide support from people in my profession; in fact, they were introduced by people in my profession. Unfortunately, they fall absolutely short of the second objective for which they were designed; namely, to separate the income-transfer effects of the subsidy from the trade-distorting effects. They simply don't do this. For this reason, I have felt that PSE's could also be regarded as D.O.A. when we get down to the tough negotiations. As we move closer to the tough negotiations, it begins to be apparent that PSE's are rapidly losing their credibility.

This leads to the most recent and newest notion of measurement, which is the whole notion of "tariffication." (One wonders whether the verb from which this noun was created is "terrify"?) Tariffication involves the measurement and transformation of various kinds of trade-distorting activities into tariff equivalents. Theoretically, it is possible to transform an import quota or even a trade-restricting non-tariff barrier into an equivalent tariff. The notion of tariffication has the advantage of providing a method of measurement, while simultaneously allowing the trade-distorting effects of a policy instrument to be separated from the income-transfer effects. This has apparently moved fairly substantially along in negotiations between the United States and Japan with respect to a number of its policies.

One must point out that the downside of the notion of tariffication is that it works fine when one is only an importer, but has totally different implications and outcomes when one is an exporter.

Hopefully, the foregoing will begin to show the complexity of the subsidy issue. At the Geneva meeting of GATT in April, agreement was made to work toward a substantial reduction in subsidies. How those reductions will occur, how they will be measured and, most importantly, what disciplines will accompany them are very difficult questions that still need to be answered.

### Tariff Reduction and Market Access

While most of the emphasis in the popular press about the GATT negotiations has been on subsidies, most of the progress that has been made over the history of the GATT has been in tariff reduction. It may be the case that, in this round, we will see even more reductions, particularly for agriculture, in tariffs on processed food products. It became clear in the negotiations on this issue in the FTA that U.S. and Canadian tariffs on final products are in the neighbourhood of 15%. One would expect that such tariffs are the same in most developed countries. As in the FTA, the obvious next step on tariff reduction is to phase these out. If this was done over time, and everything else was equal, it is quite obvious that lower tariffs would have major impacts on trade patterns and could even affect some aspects of the meat industry.

The other aspect of market access, however, is the variable import levies and quota provisions of European policy. North America would love to have better access to those

markets and the best way to gain access is to convince the Europeans to reduce the layers of protection that surround the European market. Obviously, this is tied up very substantially with the subsidy issue that I discussed above. In my view, it is not likely that much progress will be made on this issue in the current round of the GATT.

### Harmonization of Standards

The notion of harmonizing standards is much more important between North America and the rest of the world than it is between Canada and the United States. It is quite clear that the Europeans, in particular, have used standards as non-tariff barriers, especially drug, medical and health inspection standards. What is frightening for us at this stage is the fact that when the European Community becomes totally integrated in 1992, there will be completely harmonized standards within the community. They will be harmonized at a high level, most likely based on current or upcoming German standards. In many cases, the standards are very different from ours in North America and the philosophy in setting those standards is far different. The most obvious case of the differences has to do with the hormone issue which we have seen recently. Our philosophy in North America is that we want to develop procedures that keep hormone residues at acceptable levels. The European philosophy is to ban hormones.

With the integration of the European market in 1992 and a set of standards that are far different than ours, a very powerful set of competitors will be developed and they may be developed in such a way that we are precluded from competing with them in their market.

### Conclusions

In this paper, I have tried to show that there are several issues regarding liberalized trade in the context of both the Canada-U.S. Free Trade Agreement and the GATT negotiations. I have also tried to show that the issues are parallel in both contexts. The issues have to do with subsidies, harmonization of standards, market access and tariff reduction.

Let us now return to the comment I made at the beginning regarding my skepticism about whether liberalized trade would be particularly beneficial to North America. My skepticism arises from the following arguments.

The first is that I am not convinced that, in the case of beef, Canadian producers are in tune with the rest of the world or, perhaps, even North American consumers. Most of the world needs a product that has very little internal fat and is produced largely from forage. North America still wants to produce a product that is finished on grain and has a relatively high fat content. A recent survey of 1500 Canadian consumers for a project in which Dr. Ron Osborne and I are involved suggests that Canadian consumers also want a product that has very little internal fat. Because of the difference in production philosophy in North America and the consumption philosophy in Europe, I suspect that a more liberalized trading environment would be of greater benefit to Australia, New Zealand and Argentina than it would be to

North America.

The second reason I am skeptical has to do with the pork sector. While the product we produce in North America is similar to the one produced in Northern Europe and Japan, it is quite dissimilar from the product produced in Southern Europe. Southern European pork products are largely dry process sausages with considerably different characteristics than most of the sausages we produce here. They are also produced from hogs that are marketed at a weight of about 200-220 kilograms. More liberalized trade in pork may not be of particular value to us for the very large and affluent Southern European market.

The third issue has to do with the potential nature of any liberalization. Most people argue that our major advantage in a more liberalized trading environment arises from the fact that we have access to low-cost feedgrains, relative to our counterparts in Europe and Japan. However, this assumes that a more liberalized trading environment would mean that protection would be removed from livestock in Europe and Japan but not from grains. Again, this seems to me to be a rather naive assumption that professional politicians would not make: It is hardly likely that a European politician would be in favour of maintaining a pricing regime within Europe that keeps feedgrain prices at a level two to three times higher than world prices, but pulls the rug out from under livestock producers. If we assume that a more liberalized trading environment would be more liberal for both feedgrains and livestock, then we are left in the position of being several thousand miles away from the major consuming areas of Japan and Europe. We are also left in a position where we would have to compete with quite efficient and knowledgeable producers, in the case of Europe, Denmark, Holland, Germany and Northern Italy. I find it difficult to understand what our advantage would be.

The final reason I am skeptical has to do with that difference in philosophy that we have about the use of drugs and hormones in our production processes. My interpretation is that North American livestock producers would rather change the minds of consumers who don't want to eat products that contain residues of drugs and hormones than to adapt their production practices to what consumers want. My fairly considerable experience in Europe leads me to conclude that consumers there are much more concerned about the potential harmful aspects of these residues to their health than are we. Their philosophy is to remove all risk by insisting that these materials not be used. The North American philosophy has been to try to work toward a level of residue or a procedure that has a low probability of causing health problems. As a result, European consumers have a very poor perception of North American meat products. Therefore, in a more liberalized trading environment, we could have a situation in which European consumers do not want to purchase the product that North American producers want to sell. Moreover, North American producers may not want to sell the product that European consumers want to buy. From this, it seems unlikely that a more liberalized trading environment would benefit the North American sector.