THE FUTURE OF U.S. FOREIGN TRADE POLICY

WEDNESDAY, JULY 19, 1967

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON FOREIGN ECONOMIC POLICY,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 1202, New Senate Office Building, Hon. Hale Boggs (chairman of the subcommittee) presiding.

Present: Representative Boggs; and Senators Javits and Miller.

Also present: John R. Stark, executive director; John B. Henderson, staff economist; and Donald A. Webster, minority staff economist.

Chairman BOGGS. The subcommittee will come to order.

Our witnesses for today's panel are Mr. William Diebold, Jr., of the Council on Foreign Relations; Prof. Robert E. Baldwin, University of Wisconsin; Prof. Richard N. Cooper, Yale University; Prof. John Pincus, the RAND Corp.; and Prof. Lawrence W. Witt, Michigan State University.

We appreciate all of you gentlemen taking the time to come and help the subcommittee. Other members of the committee will be along shortly. We will get started.

Mr. Diebold, may we hear from you first?

STATEMENT OF WILLIAM DIEBOLD, JR., COUNCIL ON FOREIGN RELATIONS

Mr. DIEBOLD. Thank you, Mr. Chairman.

Success seems to me to bring problems rather than a surcease of effort. The Kennedy Round is the culmination of a generation of progress under American leadership to remove barriers to world trade. If it and its predecessors had accomplished less, I think we would be talking here today, as we did at intervals of 3 or 4 years over 30-odd years, about the wisdom of giving the President the power to reduce tariffs, and under what conditions. I think that remains a problem. But it is only a part of the larger problem that we have to deal with. I think trade policy is no longer solely, perhaps not even mainly, a matter of tariff policy. It has broadened.

There are two kinds of problems we face now: Those that were left relatively untouched by the Kennedy Round and those that were opened up in new ways by the Kennedy Round, so that they can only be dealt with by bringing into play matters which have ordinarily not been thought of as being in the forefront of trade policy.

The remaining tariffs on trade in manufactured goods among industrial countries fall into three categories. First, those that have been substantially cut and, for the most part, are lower than they have been in this century. We must ask ourselves: How important are these? Can we conceivably ignore some of them, or is there some way of clearing the ground by perhaps some kind of formula or acceptance of a principle or rule for reducing these tariffs other than by another Kennedy Round, which hardly seems called for at this point?

A second category of tariffs includes those which have been left relatively untouched by the Kennedy Round precisely because it has been difficult for one country, or many of them, to make cuts. And there I think we face some of our hardest problems, which will require new kinds of initiative, perhaps along the lines suggested by Eric Wyndham White, the Director General of GATT of negotiation industry by industry, looking not just to tariffs, but at a range of trade barriers.

In the third category are tariffs which would have been cut if the pattern of bargaining had been somewhat different, that is to say, a country was prepared to cut them if it got an adequate concession in return. I think there is not much to say about them except that they are among the chips for the next round in the card game.

It is now generally accepted that as the tariffs have fallen away, nontariff barriers have become more important than ever. They are nothing new. We spent a lot of time at the end of the war working on problems of quotas and the direct controls associated with exchange controls.

But with those largely out of the way, I think we are now facing a highly variegated array of restrictions of new kinds that do not fall into easily understood patterns.

Negotiating about these will raise several problems. They are too varied, in my opinion, to be covered by any kind of simple rule or comprehensive agreement of the sort that we have over the years evolved to deal with tariffs and quotas. It may be that they are susceptible of an approach that seeks to set up some sort of complaint procedure. Certain of the barriers, either types or individual barriers, can probably be dealt with by agreements, and by establishing something like a code of behavior or rules about them. However, carriers are of differing importance for different countries, so that the logic of approaching them barrier by barrier does not stand up too well to the realities of negotiation and the need to bargain with whatever one has to bargain with. Nor is it likely that negotiation about nontariff barriers can be separated from negotiation about remaining tariffs. The complex pull between the logic of separate treatment and the requirements of more collective treatment will, I think, influence our approach to these things, and have some bearing on where and how we try to deal with them. For the United States I think there are additional problems, in that the nontariff barriers do not fall under any simple legislative arrangement, and the problem of how to negotiate, what kinds of powers the President will have to have, will remain, I think, a troublesome one.

Not the least of the problems in negotiating about nontariff barriers is a lack of agreement as to what, in fact, are barriers. Some are more or less covert trade barriers and have that as their main objective. But

there are others in which the trade barrier effect is incidental to the pursuit of some other objective perhaps. Such a matter as health or safety. We are now seeing international discussions about the automobile safety arrangements which have to be adopted in this country, because they cause problems for foreign producers.

Price rules, and domestic business practice arrangements, all begin to come into the picture. And so all manner of things are drawn into what used to be simple trade negotiations about tariffs and quotas. Not the least of the problems are those surrounding border taxes which raise very complex issues and which are now, I think, only beginning to be properly analyzed.

All this need for getting into new, more complex fields has been the result of success in removing the traditional barriers to trade. And oddly, in a field where there has been much less success, perhaps even retrogression, that is, in agriculture, I find that a somewhat similar conclusion is indicated.

Far more clearly than before we are now made to see that a large part of the structure of trade barriers in agriculture, ours as well as those of the rest of the world, derive from domestic agricultural policies. And therefore, if we want to do something about these barriers, I think we have to be willing to talk internationally about the policies themselves, about such matters as prices, production controls, surplus disposal. There was a start on that in the Kennedy Round, but it failed to come to a successful conclusion, in my opinion, with the exception of the partial success in the grains agreement on surplus disposal.

Now, I do not suggest that it is easy for us or for any other country to undertake this kind of a negotiation, to talk internationally about things which are already difficult domestically. We may not be willing or able, or others may not be, to carry on the negotiations on that basis. In that case it looks as if we must accept the fact that we are facing an impasse of the sort that we have lived with for 20 years or more, but with the important difference that our exports, American exports, will be more seriously affected this time than in the past.

Once again, the problem I mentioned in regard to nontariff barriers arises. For in spite of the logic of treating agriculture separately, that may not work because it is not of equal importance as a trade matter to every country.

With regard to trade with less-developed countries, I think I shall leave the intricacies to others, with perhaps one comment. There is something of a paradox here. It seems to me that more novel ideas are being discussed with regard to LDC trade, in such matters as preferences and commodity agreements than in the other fields where I have said we need new approaches. And yet, in my opinion, some of this discussion of novelties conceals a very old-fashioned and simple problem. And that is the willingness of the developed countries to accept competition from the less-developed ones. If they are not willing to do that, then I think that any of the array of devices that are being talked about will turn out to be rather disappointing to all concerned. However, I do not exclude the possibility that precisely through the discussion of such matters as preferences—which in my opinion should have been treated as the second question, not the first—we might arrive at the basic issue. That is to say, preferences may prove to be the road to providing freer access.

With regard to East-West trade, it seems to me that we are presently in a situation in which we have very little flexibility and that we have gained very little from imposing that loss of flexibility on ourselves. If we are to undertake some change in our policies about East-West trade, the potential gains we should seek are less in commercial or economic matters than in the ability to add trade to the things we can negotiate about with the Communist countries. And this is a quite different matter if one is talking about trade with the Soviet Union than it is with regard to the trade of the Eastern European countries. And yet I think in its different way it is true of both cases. When we are talking about East-West trade we must recognize frankly that there are no proven satisfactory arrangements for organizing trade between state trading countries and market economies. But there are some possibilities. I think that therefore we have to maintain an experimental attitude. And that means as a practical matter, to be able to alter agreements over relatively short periods. I think we should understand that such approaches as bringing more of the Communist countries into GATT are not solutions to problems, but provide ways of discussing the problems perhaps in a better framework than what we have had before.

Now, in these remarks I have tended to break up the trade problem into several different ones, to speak of East-West trade, LDC trade, and trade among the industrialized countries separately. This is right, and at the same time it is wrong. It is right because I think the problems are somewhat different, and require somewhat different approaches. What is wrong about it, a slightly more subtle point, is that there is always a risk of losing sight of the fact that we are talking about a world trading system, not simply a series of pieces. Always in the postwar period, it has been an important part of American trade policy that we have had a picture in mind of what kind of world trading system we were working toward. There have been exceptions that did not fit the picture. East-West trade is one, but it has been a relatively minor thing. But I think we are now at a period when the exceptions are decreasing. Japan, which was always a special problem, still poses certain issues that do not arise otherwise, but is very far along the road toward being a full member of the trading system. It is true that we shall probably work out something with regard to the special problems of the less-developed countries which will make them exceptions to many rules. But I think we shall find that we can no longer deal with a blanket concept of "less-developed countries." We are going to have to look at the more developed and among the less-developed because they have quite different trading interests and require quite different trading arrangements. That will make it important to have some concept of a road along which developing countries might move as they become better able to m[illegible]e their way in the world trading system.

I think, finally, that the definition, or the depiction, of the world trading system we want cannot probably, be very different from what it has been. It is a system in which there is a means of reducing trade barriers, and in which the basic objective is equal treatment in international trade. This may seem banal. I think it is not so when we recall that conception of this objective has been somewhat blurred

or even absent from many discussions in recent years. Many arguments are being made and forces are at work to reduce the scope for equal treatment. Often, I think, people respond to these ideas and pressures without adequate attention to what the alernatives are, or the position this country would be in the kind of trading world we would have if we abandoned equal treatment.

This may seem an old-fashioned sentiment. But I am glad to stand on it, provided you remember, from what I said at the beginning, that the content of trade policy is going to be quite different in the next 10 years from what it has been in the last 30.

Thank you.

Chairman BOGGS. Thank you very much, Mr. Diebold.

Professor Baldwin?

STATEMENT OF ROBERT E. BALDWIN, PROFESSOR OF ECONOMICS, UNIVERSITY OF WISCONSIN

Mr. BALDWIN. The first section of my paper consists of a very brief survey of previous trade negotiations. Since this is background material that you are already familiar with, I shall skip over this part and summarize my main points concerning certain key problems that I think must be handled more adequately in the future than has been done in previous negotiations.

We are now at the point in our tariff-cutting negotiations where most of the tariff protection that was largely superfluous, has been eliminated. Increasingly, we have moved into sectors where significant resource-reallocation effects are produced by tariff cuts. If this remaining hard core of protection is to be reduced significantly at least three important problems should receive more attention than in the past:

(1) We must achieve a better balance of consumer and producer interests in economically vulnerable industries.

(2) We must devote greater efforts to the reduction of nontariff barriers.

(3) We must make the negotiating process more effective in achieving its goal of trade liberalization and expansion.

With regard to the first point—a better balancing of consumer and producer interests—I would urge that the Congress liberalize the adjustment assistance provisions of the Trade Expansion Act. There is only one way whereby consumers can obtain the benefits of lower prices that tariff cuts bring, and yet whereby workers in certain economically vulnerable industries will not suffer a deep and long-lasting reduction in their incomes. This is by a substantial adjustment assistance program that really tries to retrain and relocate workers and employers who have lost their jobs through no fault of their own. The "escape clause" portion of the act, incidentally, should not be changed, I think. This action should only be used in exceptional cases.

There is more and more interest here and abroad in trying to harmonize and reduce the many nontariff barriers that restrict world trade. These include such measures as (1) quantitative restrictions; (2) Government procurement policies; (3) customs valuation practices; (4) border tax adjustments; (5) regulations covering such mat-

ters as safety and health conditions; (6) Government subsidies to domestic industries; and (7) monopolistic practices in the private sector.

There are great opportunities for U.S. export expansion if foreign nontariff barriers can be reduced. The United States also has erected certain restrictive nontariff barriers. However, most of our barriers are represented by clear-cut laws and well-known public regulations. In many foreign countries, on the other hand, informal administrative devices are used to thwart the attempts of U.S. businessmen to sell abroad. It is important to bring these measures out into the open and establish clear-cut rules that do not discriminate against foreigners in cases where the national interest is not involved.

It will take many years to reduce these barriers, but we should start soon to undertake the time-consuming, technical analysis that will be necessary to achieve a significant reduction of these barriers.

My first point concerns improvements in the negotiating process. First, we must greatly improve the level of economic analysis supporting our negotiators. The steps outlined in the Trade Expansion Act for assessing the economic effects of tariff cuts in various industries as well as the possibilities for export expansion look impressive on paper. But the size and level of competency of the staffs of the various departments and agencies involved in this work is quite inadequate for the job. I suggest that the Congress provide a small amount of funds annually for the purpose of undertaking economic studies designed to determine the ability of workers and employers in various industries to adjust to increased import competition. These studies should be undertaken by economists both within and outside of the Government. We should immediately, for example, set up a study that will trace the economic effects of the Kennedy Round cuts as they take place. From this we can get a much better idea of the possible effects of future cuts than we have ever had.

With respect to the nature of the negotiations themselves, I would suggest that the negotiators adopt a less rigid view of the concept of "reciprocity" than is often used and that in the future we do not tie ourselves to any one tariff-cutting technique. Flexibility is essential for tariff-cutting negotiations.

A number of highly competent observers interpret our recent tariff-cutting experience as requiring radical changes in our approach to worldwide trade liberalization. Some of them suggest the formation of free trade blocs between the United States and various other industrial nations. Others propose the abandonment of the most-favored-nations principle in our tariff-cutting policies. While these various proposals have points in their favor, the merits of proceeding along the same general lines as in the last six GATT negotiations to me seem greater, especially if the goal is the economic one of lowering artificial impediments to world trade.

There is still much to be done in reducing the trade-inhibiting effects of nontariff barriers. This will be a very difficult task but there is some evidence to suggest that at least the major industrial countries are willing to proceed toward a harmonization and reduction of some of these barriers. With an effective adjustment assistance program together with an adequate background of economic analysis, a less

rigid view of the reciprocity concept, and a more flexible negotiating approach there is also still much that can be accomplished in the tariff field. We will be hampered by the unwillingness of some countries to reduce their barriers as far as we are prepared to do. But what can be accomplished by a flexible approach to tariff-cutting seems significantly preferable to the longrun economic and political risks involved in regionalization and tariff discrimination. Thus, it is not too early to begin to plan for a seventh round of GATT negotiations aimed primarily at the non-tariff-barrier problem and at expanding trade between developed and less-developed countries, but also designed to achieve further moderate cuts in duties among industrial countries.

Chairman BOGGS. Thank you very much, Professor Baldwin.

Professor Cooper, may we hear from you?

STATEMENT OF RICHARD N. COOPER, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. COOPER. Mr. Chairman, members of the subcommittee, I think it is fair to say that most people are pleased with the outcome of the Kennedy Round. There were some black moments when it looked as though little or nothing might come of it, and that would have marked a severe setback to all those who favor a liberal trading policy. I do not like to tarnish the luster of success, but it is worth pointing out that the actual results of the Kennedy Round do not in some respects mark such a sharp departure from the past which we had been led to expect. It is true that tariff cuts amounted to something like 30 percent on $15 to $16 billion of U.S. trade (taking imports and exports together, and agricultural as well as industrial goods). But these tariff cuts are to be spread over 4 years, and they stem from negotiations which took nearly 5 years. If allowance is made for the very long time over which these cuts should be averaged, the Kennedy Round was only about 45 percent better than the Dillon Round, which was widely regarded as amounting to next to nothing. Moreover, some of the cuts in the Kennedy Round do much less in the way of reducing protection than they appear to, since at least in the textile and metals industries, tariffs on raw materials were often reduced substantially more than tariffs on fabricated products.

To focus on these blemishes, however, would be to do the Kennedy Round an injustice The number of commodities covered was far greater than in the Dillon Round. Moreover, the Kennedy Round preserved the forward momentum of trade liberalization. The proper comparison is not with things as they were, but with things as they otherwise would have been. That is a comparison which we can never make with assurance, but I strongly suspect that "no change" is not a stable situation, that without some movement toward trade liberalization there would be some movement away from it. Protectionist sentiment is always present in all countries, and without some counterforce it is likely to have its sway.

Furthermore, the Kennedy Round did make a modest start—but it is only a start—toward reducing nontariff barriers to trade, especially if Congress eliminates the American selling price method of valuation.

But where do we go from here? I see three possible directions.

First, another broad-coverage negotiation, like the Kennedy Round but with more emphasis on nontariff barriers.

Second, a stalemate in trade liberalization among developed countries, but a cooperative move toward general tariff preferences given by all developed countries to all less-developed countries.

Third, piecemeal trade liberalization involving discrimination both among countries and among industry sectors. Examples of this piecemeal liberalization are already at hand in the trade agreement, between Nigeria and the EEC, in the United States-Canadian auto agreement, and in the Long-Term Textile Agreement—the last also having restrictive features.

Let me say a little about what each of these directions might look like.

The Kennedy Round negotiations were long and wearing. I am sure none of the participants welcome the thought of another Kennedy Round at this time. However, the Kennedy Round faced two hurdles which will not plague such a negotiation in the future. It was the first attempt at an across-the-board negotiation, and new ground rules had to be worked out with respect to what constituted a "bargain." Second, the EEC was being tested for the first time as a negotiating unit, and there were many problems of internal bargaining which had to be worked out. This process was complicated by the insistence of the United States on including agriculture in the Kennedy Round, an area of sharp differences within the EEC and requiring delicate compromise there.

The formative stage on both of these difficulties is now past, and I suspect another Kennedy Round beginning several years from now would go much more smoothly. One tempting approach, in fact, would to be to divide such a negotiation into two parts, the first being a straightforward replication of the Kennedy Round tariff cuts. This would use to good effect the great study and effort already invested in the Kennedy Round just over. The hard negotiations could thus concentrate on those items which escaped deep cuts in the Kennedy Round, and on nontariff barriers.

Generalized trade preferences for less-developed countries is a proposal arising out of complaints in UNCTAD concerning exporting difficulties and problems of market access to the developed countries. Several variants of this have been thoroughly discussed by a group of experts in the OECD. There seems to be much more sympathy now for this idea—and even for trade preferences given on a regional basis—than there would have been in the United States 10 or even 5 years ago. In part this sympathy arises from increasing dispair about the ability of foreign aid to accomplish the job of development; partly because the linkages between aid and development seem to be far looser than was once thought; and partly because national parliaments are increasingly reluctant to appropriate the volume of aid funds thought to be necessary. It is natural to think of growth through exports.

The idea is given further force by recent analysis concerning "effective protection," which argues that fabricating and processing industries can be and often are fully protected by relatively low tariffs combined with duty-free entry of raw materials. A tariff structure

rising with the degree of fabrication tends to locate processing industries near markets rather than near sources of raw materials, thereby depriving the raw material exporting countries of an important and natural entry into manufacturing.

Despite the appealing characteristics of generalized preferences, this course has a number of weaknesses which should not be overlooked.

First, generalized preferences will be extremely diffuse in their effects. Few countries can expect a sudden surge in demand for their exports as a result of them. No doubt they would provide a fillip to development in some areas, both by providing demand and by generating foreign exchange, but there is no panacea for development here.

Second, the advanced less-developed countries are likely to benefit much more than the less advanced less-developed countries. The former will be in a better position to take advantage of the opportunity provided by preferences.

Furthermore, this advantage will come partly and in some cases largely at the expense of the less advanced developed countries who do not get the preferences. But what rationale can there be for giving Argentine goods preferences over Japanese goods, or Mexican goods over Argentine goods, or Columbian goods over Mexican goods?

Third, the existence of large preferential areas would create a serious impediment to future liberalization of trade, since those enjoying the preferences would have a strong vested interest in retaining high trade barriers among other countries. This phenomenon has already been observed in the Kennedy round, where certain concessions were made difficult by a desire to preserve existing degrees of preference with the EEC.

Fourth, as with foreign aid, there is no guarantee that development will follow the opening of preferential markets or that it will be in the right places. Some less-developed countries will benefit, and some individuals within those less-developed countries will benefit; but they may not be the most important countries from the viewpoint of the U.S. interest in economic development, and they may not be the right individuals for fostering development.

What experience we have had to date does not give great encouragement with respect to the development gains from preferential markets. I speak tentatively here, since more careful study needs to be made of experience to date, but my impression is that the Commonwealth preference system can provide illustrations of almost every case possible—rapid growth with preferences in the British market, rapid growth without important preferences in the British market, stagnation with preferences in the British market. The former French territories have not "taken off" into economic growth despite years of preferential access to the French market and more recently to the entire EEC. I have described this process, and some current parallels from the international scene, in an article in the Yale Law Review, which I will be willing to submit for the record, Mr. Chairman, if you wish.

Chairman Boggs. We would be happy to make it part of the record, Mr. Cooper; without objection.

(The article submitted by Mr. Cooper appears on p. 231, following his statement.)

Mr. COOPER. Finally, the United States has given preferential access to Philippine goods since the 1920's. The preferences were mutual in the interwar period, so Philippine manufacturing was subject to stiff U.S. competition in manufactured goods. Since the war, however, the Philippines has imposed duties on American goods. Manufacturing in that country has grown apace, but it has been import-substituting manufacturing, protected by Philippine tariffs, not manufacturing for export. Apparently preferential access to the large U.S. market was not enough; other factors such as supply limitations, inadequate quality control, and marketing difficulties have been more important. It is true, however, that the Philippines engages in some important processing industries notably the production of coconut oil and other coconut products.

The structure of tariffs in the developed countries undoubtedly does impede industrialization in the less-developed countries. Preferential tariff arrangements would help correct this, as the U.S. arrangement does for the Philippines. But preferences are not necessary to do so. Multilateral, nondiscriminatory tariff reductions would also correct this, and could even be geared to reducing the tariffs on highly fabricated products somewhat more than tariffs on semi-fabricated products or raw materials.

I might add, parenthetically, that it is possible that the influence of tariff structures on industrial location, which I do think is an important point, is becoming overemphasized, since the effects on location of the tariff structure in advanced countries are in some instances offset by the commercial policies of the less-developed countries, which often levy export taxes on raw materials. Calculation of the net effect of all commercial policies in developed and less-developed countries alike still awaits careful research.

To sum up, preferential access to developed markets, while possibly helpful in some cases, is neither necessary nor sufficient for economic development. And it would have some positively harmful effects.

The third possible direction I mentioned is piecemeal trade liberalization. That would be far less systematic than generalized preferences. As an economist, I do not like this approach, because industrially and geographically limited preference arrangements are likely to appear here and there, helter-skelter, and the overall economic effect of these arrangements will be unclear. There will be too much tendency to focus on the narrow, "obvious" benefits from any such arrangement and to neglect the overall consequences, including indirect effects. In some cases there would be real benefit, and in others there would be real harm, and it would be difficult to sort them out clearly.

I can perhaps give a hypothetical example to illustrate this. Take the case of free trade in automobile parts between the United States and Canada. Suppose the United States has a tariff on certain key raw materials that go into automobile parts, whereas Canada does not. The free trade arrangement between the United States and Canada, limited to auto parts, may result in Canada producing the parts and exporting them to the United States even though the United States is really the lower cost source of supply at free trade prices.

This kind of outcome, I think, is much more likely than is usually allowed for, and it makes analysis of the total effects of any limited

trading arrangements very difficult. Moreover, effective geographical discrimination is notoriously difficult to administer.

But the more powerful objection to piecemeal trade liberalization rests on political grounds, not economic ones. It would reintroduce into international politics a sharply divisive element—trading privileges. Adherenece to the most-favored-nation principle has served to a considerable extent to insulate international trade from other dimensions of international politics. Abandonment of MFN would open up the possibility—indeed the likelihood—of exchanging trade favors for other favors. In the end our economic objectives could be badly maimed in the process.

It is worth recalling that the economic gain from a system of bilateral and piecemeal preference arrangements is likely to be illusory. In an international trading community in which preferences are generally ruled out, one country may gain by negotiating preferred access to major markets. Individual cases for preferential arrangements can perhaps even be justified. But once all countries move in this direction, the gains are eroded and all countries may end up being worse off than without any preferences, for while each country finds itself in a preferred position in certain markets, it is discriminated against in others; what it gains in one area it may lose in another. In addition, the advanced countries limit unduly their sources of supply, to their own detriment but without any necessary or corresponding gain to the less developed countries.

To sum up, I have an undisguised preference for the first of the three alternative courses of action which I see before us, a repetition of the Kennedy Round type of negotiation. Generalized preferences would be preferable to piecemeal trade liberalization. But as I noted, generalized preferences are neither necessary nor sufficient for economic development, nor indeed even to induce a healthy growth in manufacturing output in the less-developed countries.

A general commitment to freer trade among developed countries would also benefit less developed countries, especially by improving tariff structures: and temporary preferences could be established by giving tariff cuts at once to the less developed countries. This would conform with the infant industry arguments used to justify protection in less-developed countries. Preferential access to markets would be given, but it would automatically fade out over a period of, say 10 to 15 years, while the general tariff cuts come into effect. During this time industries could be established. Even this arrangement, however, would benefit most the most developed of those qualifying for the preferences.

Before closing, I would like to touch on one further aspect of post-Kennedy Round trade liberalization. Extensive liberalization would have important consequences for the regulatory, tax, and balance-of-payments policies of governments. Tariff reductions are not the only factor having such consequences. Reductions in transportation costs such as have been occurring over the past two decades and reductions in nontariff barriers also contribute to a general "loosening" of trade, making production less dependent on proximity to market. These developments allow business firms to locate more freely according to their economic interests, without regard to tariffs and other trade

barriers. This is good. But location may also be influenced by a desire to escape certain national regulations or tax provisions offensive to the firm. Firms can more readily locate "abroad" and export to the nations with the stiff taxes or regulations.

This process can be seen very clearly within the United States in the late 19th and early 20th centuries, when State regulation of corporate enterprise virtually collapsed because of the freedom of trade and the constitutional obligation to honor contracts made in other States. The ultimate solution, adopted in 1933, was to transfer regulatory responsibility to the Federal level; in a similar vein, further trade liberalization will imply a need to cooperate increasingly closely with other countries on such matters concerning business taxation and regulation.

But I would like here to focus on the balance-of-payments issues. There are two sides to this question. First, tariff changes have potential balance-of-payments effects, and the larger and more sweeping the tariff change, the larger will be the likely balance-of-payments effect. One role of "reciprocity" in tariff negotiations, for having a roughly balanced package of tariff reductions between countries, is that it provides a rough method for neutralizing these balance-of-payments effects and thereby insulates moves to reduce protectionism from a desire to protect the value of the national currency.

The other side of this coin is that tariffs or their equivalent could be used as a measure to help eliminate imbalances in payments. At present that GATT permits derogations from its rules for balance-of-payments reasons, and in particular article XII permits the use of trade restrictions by a country in balance-of-payments deficit. The permitted restrictions cover only restrictions on the quantity or value of trade; they apparently do not include special surcharges on imports. Yet both from an economic point of view and from an administrative point of view there is good reason to prefer surcharges over quantitative restrictions. Surcharges permit highly profitable trade to continue; they permit new entry; they do not require favoring some importers or foreign exporters over others; they yield revenue, and thereby help to damp domestic demand, which in many instances of balance-of-payments deficit is desirable. They can be imposed uniformly over a wide range of goods, and thereby have a minimum impact on the structure of tariffs and hence on the degree of protectionism. By the same token, downward tariff adjustments could be made by countries in surplus, also in the interests of better balance of payments equilibrium.

At present the conventions regarding reciprocity in trade negotiations militate against the unilateral reduction of tariffs even when a country acknowledges that would be in its best interests. Countries fear that they would be weakening their "bargaining position" in future tariff negotiations. Similarly, raising tarffs for balance-of-payments reasons leaves trade partners feeling that they have been cheated. It is ironic that measures taken to depress the domestic demand for balance-of-payments reasons—measures which may have much the same effect on imports from trading partners—do not give rise to such complaints, even though in economic terms they may be far more costly to all the parties concerned.

Despite the pressures against the use of tariffs for balance-of-payments reasons, there have been a few occasions on which they have been used. Germany in 1957 reduced its tariffs very substantially in order to help stabilize the domestic economy and reduce a payments surplus; and France made modest reductions in tariffs in 1963 for similar reasons. On the other side, Canada imposed tariff surcharges in 1962, and Britain did so in 1964, although both moves came under extreme criticism and the surcharges were short lived.

Restrictions on imports are obviously suitable only if the balance-of-payments deficit is not expected to last. If it is, the currency should be devalued. But if the deficit is expected to be temporary, it would be preferable to finance it, and this is where the link comes between trade policy and international monetary reform. In the absence of effective monetary reform, countries may not have adequate financing at their disposal to cover temporary payments deficits, and there will be occasions when temporary restrictions on imports are preferable to alternative courses of action, including the quantitative restrictions now permitted under the GATT.

Rules would have to be developed to prevent abuse of the privilege to impose surcharges for balance-of-payments reasons. Widespread coverage and uniform rates would be necessary to avoid charges of protecting particular industries. It is the currency here which the surcharges are designed to protect and not particular industries.

One way to overcome the feared loss of bargaining power would be to permit countries to time multilateral tariff reductions to correspond to balance-of-payments requirements. Thus, countries in surplus could be asked to reduce their tariffs more rapidly than countries in deficit, although all countries would be committed to ultimate reduction. This is how trade liberalization proceeded in Europe during the 1950's.

I raise these relationships between trade policy and balance-of-payments policy not with any firm view as to what is the best course of action, but with the hope of generating some discussion of two issues which, for the most part, have been kept quite separate.

Thank you, Mr. Chairman.

Chairman BOGGS. Thank you very much, Mr. Cooper.

(The article referred to by Mr. Cooper on p. 227, follows:)

NATIONAL ECONOMIC POLICY IN AN INTERDEPENDENT WORLD ECONOMY *

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During the past decade there has been a strong trend toward economic interdependence among the industrial countries. This growing interdependence makes the successful pursuit of national economic objectives much more difficult. Broadly speaking, increasing interdependence complicates the successful pursuit of national economic objectives in three ways. First, it increases the number and magnitude of the disturbances to which each country's balance of payments

*Reprinted from *Yale Law Journal*, vol. 76, No. 7, June 1967.

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A more complete exposition of the argument of this article is to be published in a book tentatively titled "The Economics of Interdependence: National Economic Economic Policy in the Atlantic Community," by McGraw-Hill Co. for the Council on Foreign Relations. "Several paragraphs of this paper were included in a talk given at the University of Michigan and subsequently published in The Economic Outlook for 1965. I am grateful for permission to reprint them here."

I am grateful to Mr. Leonard Chazen for research assistance.

ments is subjected, and this in turn diverts policy attention and instruments of policy to the restoration of external balance. Second, it slows down the process by which national authorities, each acting on its own, are able to reach domestic objectives. Third, the response to greater integration can involve the community of nations in counter-acting motions which leave all countries worse off than they need be. These difficulties are in turn complicated by the fact that the objectives of greater economic integration involves international agreements which reduce the number of policy instruments available to national authorities for pursuit of their economic objectives. This article touches on all of these facets of higher economic interdependence among industrial nations, both as fact and as objective, but its principal focus is on the third complication—the process of mutually damaging competition among national policies.

There can be little doubt about the great growth in international economic interdependence over the last two decades. Import quotas in industrial countries have been virtually abolished on trade in manufactured products, tariffs have been reduced, and transportation costs have fallen relative to the value of goods. At the same time, the accumulation of capital and the spread of technology have made national economies more similar in their basic characteristics of production; comparative cost differences have apparently narrowed, suggesting that imports can be replaced by domestic production with less loss in national income than heretofore. Whether a country imports a particular good or exports it thus becomes less dependent on the basic characteristics of the economy, more dependent on historical development and on relatively accidental and transistory features of recent investment decisions at home and abroad. An invention in one country may lead to production there for export, but the new product will relatively quickly be produced abroad—or supplanted by a still newer product—and possibly even exported to the original innovating country.

Monetary disturbances, too, are likely to be much more quickly translated into changes in the volume of exports and imports than they were formerly. Under fixed exchange rates, greater than average monetary inflation in one country will invite a more rapid deterioration in the balance on goods and services than was true in the past.

Enlargement of the decision-making domain of the world's great producing firms results in the rapid movement of capital and technical knowledge across national frontiers, thereby contributing to the narrowing of comparative cost differences; but their activity will also quicken the speed with which trade adjusts to new sales opportunities because they have direct knowledge of foreign markets and access to distribution channels.[1]

Finally, as financial markets become more closely integrated, relatively small differences in yields on securities will induce large flows of funds between countries. Banks will increasingly number "foreign" firms among their prime customers; the advantages of inexpensive credit to firms in countries with ample savings and well-functioning financial markets, such as the United States, will be shared increasingly with firms elsewhere.

All of these changes in the characteristics of the international economy during the past decade—and it should be emphasized that economic integration is still far from complete—are crucial to the functioning of the international payments system and the autonomy which it permits to national economic policy formation. These changes mean that in normal periods prospective imbalances in international payments—imbalances which would arise if countries did not respond to reduce them or did not adjust policy measures to forestall them—are likely to be more frequent and of larger amplitude than they have been in the past. "Disturbances" arising from new innovations, from generous wage settlements leading to price increases, and from excess or deficient domestic demand will affect the balance of payments more perceptibly. Whether or not imbalances also last longer depends upon the relationship among the "disturbances:" if they are well distributed among countries and tend equally toward deficit or surplus, the duration of prospective imbalances may well be less than in the past; otherwise it may be longer.

These changes suggest that balance of payments difficulties are likely to be more common in the future, and that they will worsen as the structural changes continue in their recent trend. By the same token, however, correction of im-

[1] A quick response assumes the absence of collusive agreements on price, market-sharing, and the like.

balances in international payments should be easier in the future. Trade flows will respond more sharply to given small "disturbances;" but they should also respond more quickly to policy measures designed to influence them. If a small relative increase in the price level will lead a national economy into greater balance of payments difficulties than heretofore, a relatively small decrease should undo the difficulties. Similarly, international capital flows will respond more rapidly to small differences in national credit conditions; but small differences in national credit conditions directed to correcting the imbalance can induce equilibrating flows of capital. Thus if the national authorities can recognize disturbances early, are willing to use some of the tools at their disposal for correcting imbalances in international payments, and act reasonably quickly in doing so, then the increased sensitivity of international payments to various disturbances need cause no undue difficulty—provided that policy instruments are properly chosen and adequately coordinated among countries.

INTERDEPENDENCE BEFORE 1914

There is a natural inclination to compare the international economy today, especially under the claim that it is becoming more integrated, with the international economy before 1914, when, it is often said, the world was highly "integrated" economically. In the four decades before World War I most of the major countries were on the gold standard (implying fixed exchange rates) most of the time, capital was free to move into or out of most countries, trade was impeded only by comparatively moderate tariffs and quotas were generally absent. Even labor was generally free to migrate from country to country without visas, security checks, and immigration quotas.

In one important sense, however, the comparison is not at all apt. Today national governments are much more ambitious about the objectives of national economic policy than they were in the 19th century. Governments have taken on the responsibility for assuring high levels of employment and, increasingly, a rapid rate of growth; and they attempt actively to influence the allocation of resources and the distribution of income to a much greater degree. These new tasks place greater burdens on the available instruments of policy. Before 1914, by contrast, preoccupation with "defending the currency" was dominant, and the (admittedly more limited) policy instruments at hand were more willingly devoted largely toward that end. Thus the intrusions of international economic integration on national economic policy was more readily accepted because national economic policy was far less ambitious in its aims.

In addition to this important difference, economic relations among industrial countries are probably potentially much closer today than they were even before 1914, despite the characteristics of the pre-1914 world noted above. True, British and French capital moved overseas readily and British investors built railroads around the world. The proportion of Britain's annual savings which went abroad was staggering by modern standards.[2] Nonetheless, communications were far less perfect than they are today and foreign investors ran far greater commercial risks arising from imperfect knowledge (except in the case of colonial bonds which in effect had the sponsorship of the home government).

Despite the freedom of capital to move, it did not in fact move in sufficient volume to erase differences even in short-term interest rates. Over the period 1876–1914 short-term interest rates in New York averaged more than one percentage point higher than corresponding rates in London and there was only a weak correspondence in movement between short-term rates in the two financial centers. Short-term interest rates in London and Paris were much closer together and the correspondence in their movement was higher but still far from perfect.[3] Long-term rates showed similar divergence in their levels and

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[2] ALEXANDER CAIRNCROSS, HOME AND FOREIGN INVESTMENT, 1870–1913, 104–06 (1953) estimates that in 1907 no less than 40 percent of British national saving went to foreign investment.

[3] *See* O. MORGENSTERN, INTERNATIONAL FINANCIAL TRANSACTIONS AND BUSINESS CYCLES (1959) for an exhaustive study of interest rate movements in the 19th century. The correlation coefficient between monthly averages of the commercial paper rate in New York and the open market discount rate in London was only +.45; the correlation between open market discount rates in London and Paris was +.67. Simple correlations of short-term interest rates in New York, London, Paris, and Berlin can be found in *Id.* at 109.

movement. Response to new investment opportunities was often slow when it came at all.[4]

While tariffs were generally low, barriers to trade in the form of transportation costs were very substantial, although they declined sharply after the introduction of the ocean steampship. Large differences in comparative costs meant trade was socially very profitable, but the composition and level of trade was correspondingly less sensitive to small changes in costs, prices, and quality. Finally, business organizations, far from being international, became truly national corporations in the United States only as World War I approached, and the process was even slower in many European countries.

Thus the alleged integration of the pre-1914 world economy was something of an illusion. While the pre-1914 world was "integrated" in the sense that government-imposed barriers to the movement of goods, capital and people were minimal,[5] those imposed by nature were much greater and economic integration was not high in the sense used here—quick responsiveness to differential earning opportunities.

Countries today are gradually entering a new environment, not merely returning to a state which had once existed. And they confront new problems arising from the combination of more ambitious national and international economic objectives and a higher degree of economic interdependence than has ever existed before. How, in this world, are they to maintain international equilibrium under a regime of fixed exchange rates and at the same time achieve their national objectives? It is now necessary to specify more precisely how conflicts may arise and to indicate some of the ways in which governments have responded to these conflicts.

ECONOMIC OBJECTIVES AND POLICY INSTRUMENTS

A well-known proposition in the theory of economic policy requires that the number of policy instruments be at least as great as the number of objectives (target variables) if all objectives are to be achieved.[6] If the number of instruments is fewer than the number of targets, it will not be possible to reach all of the targets; in the case at least some targets must be given up, and the authorities must choose among them.[7]

A simple example can illustrate the need to have at least as many instruments as targets. Suppose the government of an isolated country has two economic objectives; it would like to assure full employment of its labor force at all times, and it would like its national product to grow at a specified rate each year. It can vary the overall size of the budget deficit or surplus (fiscal policy) to assure full employment. But full employment of resources can be met with a variety of combinations of investment, consumption, and government expendi-

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[4] Morgenstern considers it "remarkable" that such permanent differences could be maintained for hundreds of months; "the interaction of all these highly organized money and capital markets and the vast flows of funds back and forth was not strong enough to overcome fundamental institutional and risk differences." *Id.* at 470.

[5] This is the definition used in B. BELASSA, THE THEORY OF ECOOMIC INTEGRATION (1961).

[6] A useful framework for the discussion of economic policy has been provided by the Dutch economist, Jan Tinbergen. He draws a distinction between three types of economic variables: target variables, instrument variables, and data. Target variables are those to the values of which we attach some social importance *per se*, *e.g.*, unemployment or the growth in per capita income. Instrument variables, or policy instruments, are those which the public authorities can manipulate directly in order to influence the target variables. Data are other economic variables which influence the target variables. If an economy starts from a position "on target"; that is, with all of its target variables where the authorities want them, then changes in the data are "disturbances" and call for some adjustment in the policy instruments in order to restore the desired values of the target variables. *See* J. TINBERGEN, ON THE THEORY OF ECONOMIC POLICY (1952); J. TINBERGEN, *Economic Policy: Principles and Design* (1956).

[7] In general, it will be desirable to have more instruments than there are targets. This is especially true where the relationships between instruments and targets are not well-known. More often than not, policy-makers are quite confident about the *direction* in which a given change in a policy instrument will affect the target variables, but they are not at all confident about the extent of the influence. This may be due to simple ignorance with fairly stable structural relationships, or it may be due to a rapid change in the structure of the economy.

In the presence of this uncertainty, it is desirable to have as many policy instruments as possible. None of them will be superfluous, for all can help to keep the target variables as close as possible to their targets. Each instrument variable should be used in proportion to the confidence held in its relationship to the target variables. For a formal analysis of this problem, see Brainard, *Uncertainty and the Effectiveness of Economic Policy,* 57 AMERICAN ECONOMIC REVIEW (May 1967).

ture. Without some other instrument, the desired growth rate cannot be assured. If, however, investment leads to more growth, then monetary policy and fiscal policy together can be manipulated to achieve the two objectives. The higher the growth rate desired, the lower should be the rate of interest. Fiscal policy can then be adjusted to assure full employment. This very simple model apparently influenced thinking in the early years of the Kennedy Administration.

Viewing economic policy as a problem in specifying targets and finding sufficient instruments to reach them helps to illuminate many policy problems confronting national authorities. The objective of greater economic integration has lead many officials to reject both flexible exchange rates and frequent variations in fixed exchange rates as an instrument for maintaining balance of payments equilibrium. A number of other instruments of policy have been ruled out by international agreement on the same grounds, or to avoid a round of retaliation and counter-retaliation that would leave all countries worse off than they were at the outset. Most types of export subsidies, tariff discrimination among countries, increases in tariffs, and discriminatory exchange regulations fall into this category. A number of provisions of the General Agreement on Tariffs and Trade (GATT) are devoted to these exclusions and prohibitions; with specified exceptions, such as the formation of customs unions or free trade areas, trade discrimination is proscribed.[8] So are many types of export subsidies and discrimination in domestic taxation between home and foreign goods. The Articles of Agreement of the International Monetary Fund make similar prohibitions with respect to currency arrangements. The extensive use of these measures in the past, especially in the 1930's, led to widespread retaliation and mutual recriminations, and they acquired a bad name among outward-looking officials. But the price of international rules of good behavior as set forth in the GATT and the IMF Articles has been a reduction in the range of instruments available to national policy-makers.[9]

Some usable policy instruments may be used, as a practical matter, only within a limited range. In the United States changes in the discount rate of the Federal Reserve System and (since 1962) deliberate deficits or surpluses in the government budget are both regarded as legitimate tools of economic policy; but in normal times the public is not likely to countenance a discount rate of 20 percent or a budget deficit of $50 billion. These exceed the range of acceptability; policy instruments have "boundary conditions." In the abnormal situations when such limits become operative, they withdraw an instrument from use. Sometimes these limits are not fully known until they are tested; then we discover that we have more targets (or fewer instruments) than were previously apparent.

It goes without saying that to be attainable economic objectives must be consistent. If they are not consistent, no number of policy instruments will be sufficient. One illustration in the forefront of discussion in most industrial countries involves the relationship between employment and price stability. Given the institution of private collective bargaining, is the target of "full employment" (4 percent unemployment in the United States, under 2 percent in the United Kingdom, each by its own standards and definitions) consistent with "price stability," defined, say, as stability in the consumer price index? Many economists would find a conflict.

This kind of inconsistency can perhaps be overcome by developing new policy instruments.[10] Another kind of inconsistency, especially important to national economies linked through international trade and capital movements, cannot be eliminated through the development of new instruments. Examples are objectives regarding the balance of payments, or the trade balance. Since one country's trade surplus is another country's trade deficit, it is impossible for all countries to succeed in running trade surpluses. The same is true for balance of payments,

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[8] Trade discrimination is also permitted, under Art. XIV of the GATT, when currency discrimination is permitted under the rules of the International Monetary Fund. That occurs if the IMF declares a particular country's currency is "scarce" under its Scarce Currency Clause. No such finding has ever been made, even during the period of severe dollar shortage of the late 1940's.

[9] Freedom to use some of these instruments may in any case have been more apparent than real. As noted below, export subsidies in one country raise exports only if other exporting countries do not also use them, or if importing countries do not offset them with higher duties. But that is precisely what happened in the interwar period.

[10] These new instruments would involve shifting the trade-off between unemployment and price inflation—called the Phillips Curve—enough to make simultaneous attainment of the two objectives feasible. This is the thrust of "incomes policies."

taking into account capital movements.[11] If there are n countries, only n-1 of them can succeed in achieving their independent balance of payments targets;[12] at least one must accept defeat or else fail to target values for its trade position and its balance of payments position, thereby acting as an international residual. It has been suggested that the United States played this role until the late 1950's, by taking a relatively passive position toward its payments position after the termination of Marshall Plan aid.[13]

The requirement of consistency is not merely theoretical. In 1962, for instance, all of the major industrial countries wanted simultaneously to improve their payments positions on current account. While mutual success was not logically impossible in this case, it did imply a correspondingly sharp deterioration in the current account position of the less developed countries taken together, which in turn would require ample financing from the industrial countries in the form of grants or loans. No such increase in capital movements was targeted. Thus national targets were inconsistent.[14]

THE SPEED OF ADJUSTMENT

In summary, successful economic policy requires an adequate number of economic objectives, and it requires that these objectives be consistent with one another. If either of these conditions fails, policymakers are bound to be frustrated in their efforts. Before turning to how these frustrations become manifest, however, one other point should be made: growing interdependence can slow down greatly the process by which independently acting national authorities reach their economic objectives, even when all the targets are consistent and there are sufficient policy instruments at hand to reach them. Thus in practice nations may find themselves further from their objectives than would be true with less interdependence.

High interdependence slows the speed of adjustment to disturbances if national policy-makers do not take the interdependence into account. This is because the economic authorities in different countries may be working at cross purposes. An investment boom in one country may raise interest rates both at home and, by attracting internationally mobile funds, in neighboring countries. The first country may temporarily welcome the high interest rates to help curb the boom and may also tighten fiscal policy to keep inflationary pressures in check. But the other countries may fear that higher interest rates will deter investment at home and take steps to lower interest rates. Unless this monetary relaxation is taken into account in framing fiscal policy in the first country, its authorities will find that fiscal policy has not been sufficiently contractionary. But more contractionary fiscal policy will tend to hold up interest rates, so that the monetary authorities in the neighboring countries will find they have only been partially successful in lowering their rates. Even if in the end the whole process settles to a point where the various national authorities are satisfied, it will have taken longer than if there had been close coordination between the authorities in the several countries involved. The greater the interactions between the countries, the longer convergence will take if countries act on their own.

Sometimes, of course, actions in a neighboring country can reinforce those taken at home. If in the above example the domestic investment boom transmitted inflationary pressures to a neighboring country through enlarged imports, then contractionary fiscal policy there will complement contractionary fiscal policy at home. But in this case failure to take into account the interactions between the two countries may lead to *over*-correction and excessive unemployment. This will arise if the authorities in each country decide how much they have to act when

[11] This assumes that national *definitions* concerning the balance of payments are all consistent, and abstracts from the additional complications created by disparate national definitions of balance of payments "deficit" and "surplus." See Host-Madsen, *Asymmetries Between Balance of Payments Surpluses and Deficits,* IMF, STAFF PAPERS (1962).

[12] Unless, of course, the targets all happen to be consistent, *e.g.*, if the sum of all balance of payments targets happened to add to the annual addition to monetary gold stocks.

[13] Polak, *International Coordination of Economic Policy,* IMF, STAFF PAPERS 199 (1962). The ability of the United States to take a passive position ended around 1959, when the deficit became very large and foreign officials began to call for correction. One interpretation which can be put on the international discussions to establish machinery for creating international liquidity is that it presents a search for a new residual supplier in the international payments system.

[14] Triffin has underlined the dramatic inconsistencies in balance of payments targets in the early 1960's. See R. TRIFFIN, THE WORLD MONEY MAZE 118-32, (1966).

acting alone to restore equilibrium; then when both groups act, the total effect will be excessive.

If policy decisions are truly decentralized among nations, in the sense that the authorities in each nation pursue only their own objectives with their own instruments without taking into account the interactions with other countries, then the more interdependent the international economy is, the less successful countries are likely to be in reaching and maintaining their economic objectives. This is due to the greater impact of domestic measures on foreign economies, calling forth correspondingly greater offsetting responses which in turn affect the first country. Under these circumstances, countries must either reconcile themselves to prolonged delays in reaching their objectives or they must coordinate their policies more closely with those of other nations.[15]

It has of course long been true that small countries must watch closely economic developments and policies in their larger neighbors, and they would take these developments into account. For the Netherlands, forecasting German GNP and German economic policies is a critical component to forecasting Dutch GNP. But as economies grow interdependent, the importance of *two-way* interactions increases, so that economically large countries such as Britain, Germany, and even the United States must increasingly take into account developments and policies abroad.

INTERNATIONAL COMPETITION IN ECONOMIC POLICY

In an interdependent economy, governments do not have full control over the instrument variables needed to influence the trade balance or the balance of payments. Each government can effect the domestic interest rate in an attempt to influence international capital movements or can set tariffs on imports and subsidies on exports to influence the trade balance. But success in influencing capital movements or trade flows depends on what other countries are doing. It is interest rate *differentials*, not the absolute level of interest rates, which includes the movement of capital. And it is domestic tariffs *less* foreign subsidies which influence the level of imports. There are many instruments of economic policy for which relative differences affect international transactions, but the absolute value

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[15] These ideas are complex and are best stated somewhat more formally in a technical footnote.

In matrix notation, let $y=Ax$ describe the relationship between target variables (y) and small changes in policy instruments (x). The matrix $A=[a_{ij}]$, where a_{ij} indicates the impact of instrument x_j on target y_i. Arrange the variables so that all the targets and instruments of one country are grouped together, followed by those of another, etc. A can thus be partitioned, with blocks representing individual countries running along the diagonal, and blocks representing the degree of interdependence, or interaction between the instruments of one country and targets of another, lying off the block diagonal.

Suppose that y^* represents the target values the economic authorities of the various countries would like to reach, that the targets are all consistent, and that there are enough policy instruments to reach them all, giving the authorities the correct values for these instruments. $x=A^{1}y^*$.

Suppose now that the target variables take on values different from their targets. How do the authorities react? Their reaction functions might be described by the following set or differential equations, $\frac{dx}{dt}=B(y^*-y)=B(y^*-Ax)$, which says that the authorities change their instruments at a rate which depends on how far the target variables are from their targets. If they do not take into account international interdependence, B, the matrix of reaction coefficients, will be a block matrix, indicating that each policy-maker look only at his own target(s).

The solution to this system of linear differential equations takes the form:

$$y_j(t)=y_j^*+\sum_i K_i e^{-\lambda_i t}$$

where the λ_i are the characteristic roots of BA and the K_i are constants determined by the initial disturbances. For a policy system which works in the sense that $y_j(t)$ will gradually approach y_j^*, the second term on the right is transitory. The system will be more efficient, i.e. achieve the policy targets more rapidly after any disturbance, the more rapidly this term fades away. It will fade more rapidly the larger are the λ_i.

In general, the larger the off-diagonal elements are relative to the diagonal elements, *i.e.*, the higher the degree of ignored interdependence, the smaller the smallest root will be and the longer it will take after any given disturbance to reach the target values y^*. High interdependence which is ignored gives rise to the possibility of overshooting targets several times, and it even gives rise to the theoretical possibility that targets will not be reached at all until the nature of the adjustment process is changed.

Coordinating economic policy involves not only exchanging information on targets and use of instruments, but taking this information into account when using instruments. Convergence to targets is then much faster.

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may continue to exert a strong influence on purely domestic decisions. This is true, for example, not only of short- and long-term interest rates, but also of liberal tax benefits to investment, generous depreciation allowances, lax regulation of corporate activities and a host of other measures designed to influence corporate location. It is also true of foreign trade: generous credit arrangements or credit-risk guarantees for exports may encourage total exports without improving the trade balance if other countries are pursuing similar measures.

This feature of policy instruments—that the absolute level of the instrument may have important effects domestically, but that only the level relative to that in other countries influences the balance on trade or payments—raises the question: where do the values of these instruments finally settle? International capital movements between two otherwise isolated countries will presumably be roughly the same whether interest rates are at 7 per cent in one and 5 per cent in the other or at 4 per cent in the first country and 2 per cent in the second.[16] In each case the differential is two percentage points. But what determines whether "community" interest rates settle at the higher level or the lower one? The effects on other objectives may be very different. Economic growth will be inhibited more in the first case than in the second.

This would be of secondary importance if all countries had many policy instruments at their disposal. Each country could compensate for an deleterious effects on domestic objectives arising from the value of instruments determined predominantly by the community as a whole. But as we already noted, the number of instruments and the range of values they can assume are often sharply limited by tradition or law. Indeed, it is highly likely that at any point in time a country will have as its disposal *only* the minimum number of policy instruments that it needs to satisfy important domestic political demands. Policy instruments affect the welfare of particular members of the community as well as national economic objectives, so their use will be resisted. Public expectation is that certain measures, while theoretically conceivable, will in practice not be used. Any attempt to invoke them therefore meets stiff resistance.[17]

The values which policy instruments take on in the community of nations, and the process by which those values are reached, are therefore of strong interest to the individual nations. They may not have sufficient domestic flexibility to offset the damaging effects of policy instruments which are forced to an inappropriate level by international competition among governments. As a result, greater international integration can force choices among national objectives which otherwise would all be attainable.

There are occasions in which most or even all members of the international community will find themselves worse off. The competitive devaluations and tariff wars of the interwar period offer the most striking examples; many of the proscriptions in the GATT and the IMF Articles of Agreement are designed to avoid a repetition of those events.

But competition among policies was not thereby banished on all fronts. For example, interest rates shot upward in 1965 and 1966 to levels one to two percentage points higher than those which had prevailed in most countries in 1964. Some of the increases were designed to curb domestic demand; others were defensive, to limit capital outflow. Even after domestic economies had cooled down, it took a dramatic meeting of finance ministers at Checquers, England, in early 1967, to reverse the process. Four other types of policy instruments having these characteristics have been used in the effort to strengthen the balance of payments of various countries: restrictions on government procurement, government-sponsored export promotion, tax incentives to domestic investment, and changes in domestic tax structure. The United States, faced with large payments deficits during the early sixties, made or considered moves in all of these areas: but in each case there was ample precedent abroad for doing so.

Government purchases for government use are specifically excluded from coverage by the GATT rules governing international trade.[18] The result is that a

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[16] This must be qualified to the extent that interest rates influence total savings in two countries.

[17] The inflexibility of potential policy instruments is summed up in the adage. "Any *old* tax is a good tax." Changes in taxes not only affect marginal decisions—that may be the objective—but also capital values which the marketplace has adjusted to allow for the old tax. Thus changes in taxes often result in capital gains for some and capital losses for others.

[18] GATT, Art. XVII(2).

conspicuously small proportion of a government purchases, by any government, is from foreign suppliers who compete with domestic producers. In the United States the Buy American provision—which since 1954 officially gives preferential treatment of six to twelve per cent (in addition to tariffs) to domestic over foreign competitors for the Government's custom—has existed since the 1930's. But in 1962 a number of government agencies, including most importantly the Department of Defense, raised the preference accorded to domestic suppliers as high as 50 per cent.[19] Foreign aid expenditures by the American government are even more restricted. Starting with development loans in 1959, such expenditures were tied increasingly to purchases in the United States, until by 1965 only a limited class of expenditures was not so tied, regardless of the price advantages offered by foreign suppliers.

The government procurement practices of other countries are more difficult to document, since most governments do not require open bidding on government purchases with well-publicized preferences for domestic producers, such as those found in the Buy American provisions. Many countries follow the practice of tying foreign assistance, either by law or skillful selection of projects and recipient countries, to purchases from the donor country. This is as true for those donors with fully employed economies as for those with excess capacity and case, and merely stimulates additional imports—and it is as true for donor countries in balance of payments surplus as for those in deficit. Canada, Japan, and the United Kingdom tie the bulk of their foreign assistance, and France ties some expenditures. France and the Netherlands give virtually all of their foreign assistance to colonial or former colonial areas, where de facto aid-tying takes place through the long-established trading firms. German aid often originates with requests from prospective exporters who have found projects in recipient countries eligible for foreign assistance by German criteria.[20]

Many of these practices, of course, arise not only from balance of payments considerations but also from protectionist sentiment. Domestic producers apply strong political pressures on their governments to buy at home—the more so when the goods are to be "given away." But weakness in the balance of payments often strengthens their arguments and increases public acceptability of such restrictive measures.[21]

Government activities are not solely restrictive of trade. On the contrary, a second range of practices involves all kinds of schemes, except direct subsidies proscribed by GATT, to promote exports of goods and services. Governments sponsor trade fairs, product exhibitions, and other advertisements for the products of their exporters; they insure commercial and so-called non-commercial risks involved in exporting; and they often help to finance exports directly. No major industrial trading nation can be found without a government or government-sponsored agency for insuring and/or extending credit for exports. Some countries, such as France and Italy, give especially favorable treatment to export paper in their banking systems or at their central banks. And export credit is often exempt from general credit limitations to restrict domestic demand. All of these measures really subsidize exports, although it is often impossible to identify the amount of the subsidy to any particular sale.

The United States established the U.S. Travel Service in 1961 to attract foreign tourists to the United States. European governments have been aiding tourism much longer, and each year spend substantial amounts for the purpose of attracting foreign tourists. Moreover, expenditure for tourist promotion has been growing rapidly, doubling every two to four years. In addition to straightforward publicity, most European countries subsidize the hotel industry either through preferential tax treatment or through low-interest or government-guaranteed

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[19] The Department of Defense also introduced, and then raised, a margin of preference to American suppliers for its procurement for use by American forces abroad, which procurement was not subject to the Buy American Act (41 U.S.C. § 10). The change added an average of 26 per cent to the budgetary cost of those items shifted from overseas to domestic procurement. *See* testimony of Charles Hitch, Comptroller of the Defense Department, *Hearings on Balance of Payments Before a Subcomm. of the Senate Comm. on Banking and Currency*, 89th Cong., 1st Sess., at 156 (1965).

[20] On national practices and their economic effects, see Cooper, External Assistance and the Balance of Payments Donor Countries, U.N. Doc. E/Conf. 46/141, Vol. V, at 360–78 (1965).

[21] When the European common market is finally established, member governments will be obliged to give equal access to suppliers throughout the E.E.C.

loans.[22] In most countries these programs date from the late fifties or the early sixties.

Subsidies to domestic investment is the third area in which governments have moved to improve their international payments positions. Investment subsidies for manufacturing and agriculture improve the competitiveness of a country's products in world markets. Some countries give direct tax incentives to new investment in plan and equipment, such as the investment tax credit of 7 per cent adopted by the United States in 1962 and the 30 per cent investment allowance in the United Kingdom. Japan permits greatly accelerated depreciation of assets. A rough impression of the influence of these arrangements can be gained from Table 1, which indicates the speed with which new equipment can be written off, taking into account investment allowances and tax credits. Table 2 indicates the susbtantial incentive to invest which accelerated depreciation and investment allowances provide in some countries by reducing corporate profits taxes.

Under a regime of fixed exchange rates, government subsidy for domestic investment is similar to a devaluation of the currency in that it improves the cost competitiveness both of the country's export products and of its products which compete with imports.[23]

Subsidies to investment are obviously motivated by considerations extending well beyond the balance of payments; economic growth has become a target of economic policy in its own right, partly for political and strategic reasons (arising in part from the "economic race" with the Soviet Bloc), partly because rising standards of living are universally desired. But balance-of-payments considerations do play an important role in the decision to inaugurate investment incentives. Britain for years has emphasized the need to enlarge and improve its capital stock to compete more effectively in world markets. And former U.S. Secretary of the Treasury Dillon, testifying on behalf of the U.S. investment tax credit in 1962, argued that the measure was required "if U.S. business firms are to be placed on substantially equal footing with their foreign competitors in this respect. It is essential," he said, "to our competitive position in markets both here at home and abroad, that American industry be put on the same basis as foreign industry. Unless this is done, increased imports and decreased exports will unnecessarily add to the burden of our balance of payments deficit."[24]

TABLE 1.—PERCENTAGE OF INVESTMENT IN PLANT MACHINERY ALLOWED TO BE WRITTEN OFF FOR TAX PURPOSE

	In 1st year	By 5th year	Cumulative total over asset life
Belgium	22	92	(1)
Canada	30	71	100
France	25	76	100
Germany, Federal Republic	20	67	100
Italy	25	100	(1)
Japan	43	68	(1)
Netherlands	26	86	110
Sweden	30	100	100
United Kingdom [2]	65	91	130
United States [3]	29	78	114

[1] Not available.
[2] Including an investment allowance of 30 percent.
[3] Including an estimate for the effect of an investment tax credit of 7 percent.

Source: Report of the Committee on Turnover Taxation, London: Her Majesty's Stationery Office, Cmnd. 2300, March 1964, p. 52; and Revenue Act of 1962, hearings before the Senate Committee on Finance, 87th Cong., 2d sess., Apr. 2, 1962, p. 82.

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[22] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TOURISM IN O.E.C.D. MEMBER COUNTRIES 22 and Annex I (1963).

[23] Investment subsidies differ from straightforward currency devaluation, however, in that the improvement in competitiveness varies from industry to industry according to the capital-intensity of the productive process, and in general they encourage the use of more capital intensive methods of production.

[24] HEARINGS ON H.R. 10650 BEFORE THE SENATE COMM. ON FINANCE, 87th Cong., 2nd Session, pt. 1, at 88 (1962). It is noteworthy, moreover, that investment incentives are usually directed at the manufacturing industries, *e.g.*, those whose goods are important in international trade. An important exception in some countries is housing.

TABLE 2.—STATUTORY AND EFFECTIVE CORPORATE INCOME TAX RATES

	Earnings fully retained		Earnings fully distributed	
	Statutory rate	Effective rate [1]	Statutory rate	Effective rate [1]
Belgium	30	30	30	30
France	50	46	50	46
Germany, Federal Republic	56	53	32	30
Italy	36	32	15	13
Luxembourg	45	32	45	32
Netherlands	45	37	35	29
United Kingdom	54	39	24	18

[1] Computed on the basis of straight line depreciation on the assumption of a constant before tax rate of return of 20 percent over the life of the investment and a market rate of interest of 5 percent.

Source: Peggy Brewer Richman, "Depreciation and the Measurement of effective Profits Tax Rates in the European Common Market and the United Kingdom," National Tax Journal XVII (March 1964), p. 90.

Changes in the structure of domestic taxation, and in particular the "mix" between direct and indirect taxes, constitutes a fourth area in which governments have moved, or have been tempted to move, to improve their national trade positions GATT rules prohibiting export subsidies have been interpreted to preclude remission of direct taxes on exports but to permit remission of indirect taxes. Thus taxes on the corporate profits arising from export cannot be rebated, but manufacturers excise taxes or turnover taxes can. Similarly, countries are permitted to levy indirect taxes, but not direct taxes, on imports. Because of this asymmetry in border tax adjustment, it is possible under fixed exchange rates for a country to stimulate exports and to impede imports by shifting its tax structure from direct taxes to indirect taxes, provided that direct taxes affect prices.

The GATT rule is based on the classical economic assumption that indirect taxes are shifted entirely to the purchaser, while direct taxes are not shifted at all, being absorbed entirely (in the case of the corporate profits tax) by the firm. Recent work in the field of public finance suggests, however, that there may be much less difference in the price effects of, say, corporate profits taxes and manufacturers' excise taxes than was once thought to the be the case.[25] To the extent that indirect taxes are partially absorbed by the producer, or that profits taxes are partially shifted forward to the consumer, the GATT rules regarding border treatment of national taxes allow some "subsidy" to exports and a country can improve its trade position by switching from corporate profits taxes to excise or turnover taxes.

Some countries have made tax changes in this direction, and others have been urged to do so. Sweden reduced its income tax and imposed a general sales tax in 1960; in mid-1964 Italy reduced payroll taxes (which are not rebatable) and, to recoup the revenue, increased turnover taxes (which are rebatable). The German government in 1967 approved a change from a turnover to a value-added tax which will improve the export competitiveness of German products;[26] and Britain has been periodically urged to increase its indirect taxes and lower the direct corporate taxes, although a special committee set up to examine the matter rejected the proposed change.[27] Similar changes have been proposed for the United States.

Once again, many considerations have influenced these proposals; in some cases there may be powerful arguments for making the change regardless of the effects on the balance of payments. But it is interesting to note that these proposals have come alive only since the late 1950's, as international competition has stiffened, and that improvement in the trade balance is often mentioned

[25] M. Krzyzaniak & R. Musgrave, The Incidence of the Corporation Income Tax, chs. 6, 8 (1963); Stockfish, *On the Obsolescence*, Public Finance 125–148 (1959).

[26] Because rebates under the turnover tax, due to complications in calculating the exact burden of the tax on each commodity, are lower than the values of rebates—and import levies—that would be permissible under the GATT rules.

[27] Report of the Committee on Turnover Taxation, Cmnd. No. 2300 (1964) In late 1964, however, Britain did increase tax rebates on exports by extending the definition of rebatable excises to include taxes on fuels and office supplies and equipment. The rebates were estimated at about 3 per cent of the value of affected exports.

explicity as an important reason for making the change. The Committee for Economic Development has stated, for example, that "a major advantage of a general excise tax (over a corporate profits tax) is that it would tend to improve the ability of the United States to compete with others in world markets," and it goes on to argue that the United States must "equalize" its tax structure with that of the Common Market as tariffs between the two trading areas are reduced.[28]

All of these policy measures have a common characteristic. Taken by one country alone, each represents a concealed devaluation of the currency, at least with respect to a selected class of transactions. But like devaluation, these measures are effective only if other countries do not respond in kind. To each country, tying foreign aid and giving preference to domestic producers in government procurement may appear to offer a means to improve the balance of payments; and indeed in the short run it may do so. But if all countries follow the same practices, the benefit to each is much reduced and some countries will have their payments positions worsened as a result. In the meantime, the total real value of foreign aid has been reduced by reliance on high cost suppliers, and inefficient production has been fostered.

The same thing is true of the other measures discussed. General adoption of export promotion schemes and government-sponsored tourist publicity will surely have a much greater effect on the total level of world exports and tourism than on the payments position of any one country, since the measures will largely cancel one another and leave only residual effects on the balance of payments. Similarly, if all countries adopt sepcial tax incentives for domestic investment, the net improvement in competitiveness—which depends as much on incentives abroad as on those at home—will be haphazard and unpredictable. The principal effect may well be not on any one country's balance of payments position but on the total investment and the rate of growth in the world economy at large—so long as these effects are not nullified by a competitive rise in long-term interest rates! Finally, an effort to raise exports and impede imports through changes in domestic tax structure may have little overall effect on foreign trade and leave countries with tax structures which many would prefer not to have.

At any point in time there are often cogent and persuasive arguments for introducing one or more of these measures to improve the balance of payments. If other countries did not respond in kind, the desired improvement would be forthcoming. But if other countries act likewise, the measures largely cancel out. Not only is the purpose of the move nullified, but all countries may find themselves worse off in terms of their other objectives. As a rule, individual countries cannot act unilaterally without inviting reaction. If they are successful, they are quickly emulated by their neighbors, so that the initial gains are transistory at best. Countries often must act in self-defense, in response to the behavior of their trading partners. This is particularly so when measures to reduce one country's deficit do not reduce the surpluses of the surplus countries but increase the deficit of another deficit country or move countries in balance into deficit. These third countries then feel compelled to respond defensively and their actions in turn increase the deficit of the initial country. Moreover, many of the measures thus taken are difficult to reverse—countries do not readily contract export credit programs or lengthen the periods of depreciation allowable for tax purposes.[29]

Today there is little obvious competition among policies, such as the round of tariff increases in the late twenties and the competitive depreciations of the early thirties. But more subtle and sophisticated methods can substitute, albeit imperfectly, for currency depreciation. Taken in sequence by different countries, these measures produce a kind of ratchet effect. We then have a series of competitive depreciations in disguise.

In this case it is balance of payments difficulties, actual or feared, which give rise to the undesirable competition in policies. Competition for the location of industry can also weaken economic policy in the area of regulation and taxation, due to the mobility of business. To attract new firms or to keep the firms they

[28] COMMITTEE FOR ECONOMIC DEVELOPMENT, REDUCING TAX RATES FOR PRODUCTION AND GROWTH 39–40 (1962).

[29] There are some exceptions. Measures which are subject to a time limitation can be allowed to lapse. As an anti-inflationary measure, Germany finally permitted its provisions for accelerated depreciation to lapse in 1960— after the years of large payments surpluses.

have, local authorities may eschew tax or regulatory measures which in the view of the authorities would benefit the community as a whole, but for the possibility of driving away investment.

National governments have not yet engaged in a scramble to adjust their policies to be most attractive to foreign-owned business firms; on the contrary, a number of countries are concerned about the amount of foreign control already present. Differences in taxation and other measures relating to business activity do, however, affect international corporate location, and some beginnings of national competition for this location can be seen. Luxembourg liberalized its depreciation allowances and offered an investment allowance in 1962 in what appeared to be a deliberate move to attract foreign investment for operations throughout the European Common Market. Belgium and the Swiss cantons have also adopted tax and other features designed to attract foreign enterprise.[80]

Policy Competition Within the United States

This intrusion of outside considerations on "domestic" policies is a familiar phenomenon to Americans, who can observe at close hand relationships among the States of the Union. The United States represents, by itself, a large and highly integrated trading economy. Under the Federal system, governmental entities with important responsibilities are often much smaller than the regional "economies" which they serve. Though nominally sovereign in many areas, the states are in fact closely circumscribed in what they can do, and they are sometimes compelled in self-defense to take repugnant measures. Corporate regulation and tax policy both illustrate this process.

State corporation laws were originally the most popular and effective way of regulating incorporated businesses.[81] In 1886, for example, Massachusetts passed new corporation statutes designed to prevent fraud or mismanagement by firms incorporated in the state. The directors and officers of Massachusetts corporations were made personally liable to creditors if the firms' debts exceeded their capital. The valuation of new stock had to be approved by the State Commissioner of Corporations. So long as similar laws prevailed in other industrial states, Massachusetts corporations had little to gain from incorporating elsewhere.

The system of corporate regulation through state law became unstable during the following two decades. First New Jersey, then Delaware began to exploit the provisions in the U.S. Constitution prohibiting impediments to interstate commerce and requiring that contracts made in any state be honored in any other state. New Jersey liberalized its laws of incorporation in 1896 by allowing new stock valuation to be entirely at the discretion of the corporation directors; it had earlier permitted debts to exceed capitalization. Both provisions laid the basis for the Standard Oil Company and other giant firms incorporated in New Jersey. The state benefitted from a modest tax on the value of corporate capital.

New Jersey's bid for corporations undermined the regulatory corporation laws of other states. Massachusetts corporations, for example, could circumvent regulation simply by incorporating in New Jersey, and a strict Massachusetts law would fail in its purpose. In 1902 a special Massachusetts commission reported "a general practice" of organizing corporations outside Massachusetts to do business within the state. The commission drafted a new, permissive corporation law which was enacted virtually without change a year later. The restrictions of 1886 were largely eliminated.

In a series of laws starting in the first decade of the twentieth century Delaware relaxed greatly its restrictions on incorporation, and in the end maintained virtually no requirements regarding the capital structure of a corporation registered in the state. Directors were not closely bound by their charters in issuing new stock. Illinois had tried to police the capital structure of corporations, but in 1933 it virtually adopted the latest Delaware revisions of 1927 and 1929, illustrating a kind of Gresham's Law in corporate regulation. In the same year, however, the Federal government undertook much greater responsibility for regulating public stock issues under the Securities and Exchange Act.

State taxation provides a second illustration of the severe constraints imposed on the states by close competition with their neighbors. Wide taxing powers are

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[80] Furthermore, the relaxation in France's tough policy on foreign investment may have been dictated in large measure by the prospect of losing investment to other members of the EEC which would nonetheless have free access to the French market.

[81] This history is taken largely from Dodd, *Statutory Developments in Business Corporation Law, 1886–1936*, Harv. L. Rev., 27, 32–35 (1937).

nominally reserved to the states. Yet while authorities in state taxation complain bitterly about the large differences in tax structure and tax treatment of business income and commodities from state to state, these differences are very narrow compared with those between countries. Commodity taxation is predominantly at the retail level—the administratively simpler manufacturers' excise tax is virtually non-existent—and the rates are very close to one another, particularly between contiguous states. State taxation of corporate income also tends to be much the same from state to state, and differences in rates, coverage, and definition of taxable income have narrowed over time.[32]

The reasons for increasing uniformity are obvious enough. The freedom of commodities, capital, and persons to move from state to state without legal impediment, and the ease with which they do so, reduces greatly the scope for wide differences in tax treatment since both purchasers and sellers will leave the high tax states. A striking example of the pressures toward uniformity is provided by North Carolina's adoption in 1957 of a new tax law which changed the basis for calculating state taxes on the net income of corporations engaged in interstate commerce. The new law had the effect of reducing the tax burden on out-of-state corporations making interstate sales from bases in North Carolina and, moreover, it relieved in-state corporations from paying North Carolina income taxes on income derived from out-of-state sales.[33] The tax change was frankly designed "to encourage more industry to locate and expand in the State."[34] Within three years South Carolina and Virginia had adopted essentially the same formula, as the governor of South Carolina explained, "to keep competitive."[35]

Under this pressure of acute competition for industry, measures are taken which benefit industrial firms but which, since most states are following similar practices, may not much affect the actual location of industry. It is not surprising, therefore, that there are perennial cries for greater coordination of state taxation, and even for uniformity. In 1957 the National Conference of Commissioners on Uniform State Laws approved a model Uniform Division of Income for Tax Purposes Act which would eliminate the pointless competition among states in their tax laws. But to date only three states have adopted the approved act in its entirety, and even then not without modification;[36] no state acting alone has much incentive to adopt it. Hence, even state tax commissioners and others who might be supposed to be jealous of states' rights have called on the federal government to impose uniformity on state taxation of corporations engaged in interstate commerce (which means in effect virtually all direct taxes on business).[37]

A noteworthy feature of this competition among the states is that much of it arises from the mobility of business. Taxation and regulatory activities are less effective if the range of feasible business locations exceeds the jurisdiction of the taxing of regulatory authorities. State regulatory laws began to lose effect around the turn of the century when American corporations increasingly became truly national in their operations.

To some extent, however, similar problems arise from mobility of persons, especially when a metropolitan area is made up of several governmental jurisdictions, persons working in the area can choose to live where taxes are lowest even while enjoying the public benefits of the central city.

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[32] *See Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, State Taxation of Interstate Commerce*, H.R. Rep. No. 1480, 88th Cong., 2d Sess., 95–136 (1964). *See also*, J. MAXWELL, THE FISCAL IMPACT OF FEDERALISM IN THE UNITED STATES (1946) especially Ch. XIII.

[33] The first of these two features recalls some of the tax privileges of foreign corporations setting up sales offices in Switzerland. The second, amounting to a remission of direct taxes on export sales, would at the international level be a clear violation of GATT rules.

[34] Advertisement in N.Y. Times, Nov. 17, 1957.

[35] STATE TAXATION OF INTERSTATE COMMERCE, *supra* note 32, at 123–26.

[36] *Id.* at 133.

[37] The situation is actually somewhat more complicated than this implies. States, faced with rapidly increasing needs for revenue, widened their business taxes considerably during the fifties to include a number of taxes touching significantly on interstate commerce. In 1959 the Supreme Court in Northwestern Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959), upheld the right of Minnesota to tax the net income of an out-of-state business arising from sales in the state. A series of decisions on related cases made clear the wide taxing powers of the states. The business community was alarmed, and in late 1959 Congress passed a law limiting the rights of states to tax interstate commerce. Many states resented the limitation of their taxing powers, but—caught between rising revenue needs and competition with other states—urged the Congress to legislate *uniform* standards for defining tax base, apportioning income, etc. *See Hearings on State Income Taxation of Mercantile and Manufacturing Corporations Before a Special Subcommittee of the House Committee on the Judiciary*, 87th Cong., 1st Sess., at 367 (1961).

IN SUMMARY

In a highly integrated economic area which surpasses in size the jurisdiction of governments, each group of policy-makers is subject to such strong interactions with the surrounding area that the constraints actions become very severe. Indeed, in the hypothetically limiting case, these constraints determine entirely the course of action each jurisdiction must take. The region—or the nation—in a highly integrated economy becomes analogous to the perfect competitor—or at best the oligopolist—in a market economy. The range of choice it has, consistent with economic survival, is very small; for the most part it simply adapts its behavior to stimuli from outside. Awareness of the high interactions will eventually inhibit action.

A. C. Pigou and John Maynard Keynes pointed out long ago that the sum of individual decisions by consumers and producers may not always be optimal for society as a whole (and hence for its members), even though its members may be acting individually on entirely rational grounds.[88] Some kind of collective action is therefore required to produce an optimal outcome.

The same can be true among nations, or among regions within a nation, if the interactions among their decisions are sufficiently strong. One jurisdiction gropes for new instruments in an attempt to improve its position. If it succeeds, others follow and there is a competition in policies which defeats everyone's objectives and in fact can even lead all participants *away* from their national or local objectives, like the members of a crowd rising to their tip-toes to see a parade better but in the end merely standing uncomfortably on their tip-toes.[89]

[88] A. PIGOU, THE ECONOMICS OF WELFARE (1932). This was also the central underlying message of J. KEYNES' GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY, (1936).

[89] A recent illustration of this, drawn from the United States, is provided by the growing use by States and municipalities of their privilege to float tax-exempt securities for the purpose of raising funds for new businesses locating there. This practice was used by only three states as recently as 1956 with such issues totalling less than $2 million; but by 1966 these issues had been made in 28 states and exceeded $500 million. As the process spreads, the actual effect on the location of industry diminishes, and the net effect will simply be to erode the Federal corporate tax base and to raise interest charges on all tax-free state and municipal securities, thus in the end hurting the protagonists in the process.

A simple game offers a suggestive if inexact analogy to the consequences of policy competition. Consider a "game" in which each of two persons must name an even number between two and ten. If they name the same number, each player receives half of that number. If they name different numbers, the player naming the lower number wins the number he named; the other player wins nothing. The "payoff matrix" for either player looks like this:

Number chosen by 1 player	Number chosen by the other player				
	2	4	6	8	10
2	1	2	2	2	2
4	0	2	4	4	4
6	0	0	3	6	6
8	0	0	0	4	8
10	0	0	0	0	5

Maximum joint gains are reached if both players choose ten; in that case each of them wins five. But for each player the choice of "eight" dominates the choice of "ten" in the sense that the payoff is sometimes higher and is never lower, no matter what the other player chooses. If the choice of "ten" is ruled out by both players on these grounds, the choice of "six" then dominates the choice of "eight" by reasoning similar to that above; and so on, until both players end up choosing "two" as the only safe strategy yielding some sure payoff.

The mutual gains from cooperation are obvious in this case, and should be obvious to both players. The temptation to cheat will always be present, but if the game is played again and again the long-run loss from deviating from a jointly agreed choice of "ten" should induce both players to stick to their agreement. If, however, this kind of game is extended to include many players—each player wins if he names the lowest number, alone or in common with others, but nothing if someone else names a lower number—any one player may feel he can violate the agreed conventions to his own benefit without inducing retliatory action by all the others. Since *all* the participants may reason in this way, all may be made worse off than necessary.

International trade and financial policies have something of this character: *if* all the other players adhere to the rules which benefit all, any one of them may gain by deviating from them, and therein lies the risk of unraveling. The rules will be workable only if all play by them.

An invisible hand seems to be working in the area of economic policy as well as in the market place. Competition in the market place is alleged to lead to the most efficient allocation of resources. Whatever the merits of this claim, we can be much less confident that competition among policies will be optimal. Governments seek many ends, not the efficient allocation of resources alone; and the process of policy competition can certainly thwart some of those objectives.

Existing rules of international behavior as set forth in GATT and in the IMF Agreement do limit the use of direct and straightforward means of policy competition such as open export subsidies and multiple exchange rates, and they therefore slow the process of policy competition since the more subtle and sophisticated methods—loopholes in GATT and the IMF Agreement—usually involve strong domestic considerations which delay their implementation. But existing rules do not fully accomplish the air of preventing self-defeating policy competition and of freeing domestic policy measures to pursue largely domestic objectives. Moreover, the pressures on domestic policy are likely to become greater as the world economy becomes more interdependent. Freedom of action in economic policy formation can be lost through the need for each country to compete in policies with its competitors in commerce.

To minimize adverse effects from this competition, countries can coordinate closely their national economic policies, attempting to define and reach an optimum combination of policies for the community as a whole. This route involves extensive "internationalization" of the process of economic policy-making, transferring this governmental function to the larger integrated area.[40]

Alternatively, countries can attempt to remove the major source of pressure on their actions—deleterious effects on their international payments positions—by providing each country with ample liquidity to finance any deficit and allowing it to go its own way. Or this goal can be accomplished by reversing the process of economic integration, artificially breaking down or reducing the numerous economic links between countries. While some movement can be seen on all three of these fronts, actions in the United States and Europe in the mid-sixties seemed dangerously pointed toward the third alternative.

Chairman BOGGS. We will be pleased to hear from Mr. Pincus at this time.

You may proceed, sir.

STATEMENT OF JOHN PINCUS, THE RAND CORP.

Mr. PINCUS. Mr. Chairman and gentlemen, after hearing Mr. Cooper's succinct and brilliant paper, I am not sure that it is really necessary for me to say anything. But for the purpose of disagreement, I will say a few words.

I don't look upon the future of U.S. trade policy as being primarily an economic matter. I think that the future of the U.S. international economic policy could most usefully be considered by both the legislative and executive branches against the broader background of U.S. foreign policy objectives.

Now this raises a basic difficulty in recommending or adopting any set of future trade policies in today's perspective, because the U.S. Government has not yet developed a set of international political goals which is consistent with the realities of the emerging world power situation as of today. It is easy enough for all of us to say

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[40] The same is true for regulation and taxation as well as balance of payments policies. A governmental unit spanning a territory which equals or exceeds the locational domain of the firm can make and enforce regulations without inviting socially undesirable relocation of industry. As the locational domains of business firms increase, it is necessary also for the jurisdictions of governments to increase correspondingly—at least in some dimensions—if subsequent "policy competition" among governments is not to result in practices and policies which are socially sub-optimal. Water and air pollution control provide topical examples. It is this, rather than the narrower question of possible misallocation of resources, which suggests that the pressure for "harmonization" of policies—*i.e.*, joint decisions—makes sense.

that the United States seeks a stable world order in which each nation is free to pursue its own destiny, safe from both external aggressions and those forms of internal subversion that if successful would aid the interests of powers hostile in the United States. Such statements had a very specific meaning in the first two decades after World War II. They took policy in the form of our aid to the reconstruction of Western Europe, and the containment of Soviet expansion, in efforts to promote the economic growth and political ability of the underdeveloped countries. Today all of that is changing rapidly.

A variety of factors account for the changing political scene: the emergence of China as a prospective major military power, the increasing political independence of Western Europe from the United States, the analogous growth of a restricted political independence in Eastern Europe, and the increasing evidence that there is little—and I would virtually say, no—relation between economic aid and political stability in underdeveloped countries. All of these issues offer testimony that the political vistas before us are likely to be incompatible with present world views, acted on not only by the U.S. Government, but also by the governments of other major countries, whether they be friendly, hostile, or neutral to the United States. In a world where the United States and the Soviet Union are dominant but not paramount powers, with China emerging as a lesser, but nonetheless formidable world power, and the underdeveloped countries clearly marching to their own drummers, our preconceptions about a world order based on the earlier uneasy Soviet-United States balance are becoming increasingly incompatible with reality in the world as it faces us today; and will, I suggest, become more and more incompatible.

Now these are, of course, far broader issues than U.S. trade policy which is our concern today. But I do not agree with Mr. Cooper in saying that it is useful to insulate economic policy from politics. My disagreement is not a matter of value systems, I just don't think it is possible to divorce trade policy from politics.

Therefore, I believe that the changing world political scene is among the basic factors which should influence the nature of trade policy decisions that the United States does make. And I suggest that this factor must lead us to a thorough reconsideration of our foreign trade, aid and investment policies.

U.S. international economic policy is now based on the concept of a liberal nondiscriminatory world trading system, with four exceptions to the general principle:

First, we maintain special barriers to trade with unfriendly nations.

Second, we maintain special barriers to products that can compete too effectively with high cost U.S. production, whether of farm or factory, as Mr. Witt points out in his testimony.

Third, we accept discrimination as long as we consider that the discrimination helps our political interests—the EEC, the EFTA, the proposed Latin American Common Market, the Central American Common Market, and other blocs, which I am sure will emerge and which we will accept.

And, fourth, we also intervene in capital markets and in the regulation of U.S. Federal procurement policies to protect, as deemed desirable, the U.S. balance-of-payments position.

Now, I believe it is an open question—I haven't prejudged it—as to whether either the basic policy or the exception will in the years ahead be the most appropriate technique for promoting American interests. And I interpret these interests broadly, in terms of the world picture.

Obviously this is something which I cannot cover in 15 minutes of testimony today. And I don't know enough about the subject to do it, anyway. So, let me address myself to a more modest analysis, and a more restricted range of subjects: the future of U.S. trade policies toward developing countries. The following remarks are not based on any more extensive reconsideration of policies which I believe must be evaluated as a matter of interest to the U.S. Government.

In more specific framework, there are four elements that seem particularly relevant today. The first is preferential treatment for the manufactured products of poor countries in the market of rich nations.

The second is to increase the mutual interests of the United States and the underdeveloped countries in expanding their trade and investment ties.

The third is to deal with the problems besetting the commodity trade that currently provides 85 percent of underdeveloped countries' export earnings.

And the fourth is to improve, by a more intensive technical analysis, our knowledge of the effects of alternative trade policies on the economic interests of the United States and other nations.

These four matters themselves raise policy issues of some complexity, which in this statement, for brevity's sake, receive bare mention, or in some instances, not even that.

Tariff Preferences

My first subject is tariff preferences. I favor the extension of tariff preferences by the United States and the other rich countries to underdeveloped countries. These preferences would confer upon the poor countries a competitive advantage in the U.S. market over nonpreferred suppliers, in the same manner that Commonwealth preferences and EEC preferences now provide for the countries that qualify under their systems. In order to avoid an excessive competition among different preferential systems, or the creation of divisive rich-poor trading blocs, it would be best if a general preferential system could be based on common principles subscribed to by all preference-granting and preference-receiving nations. However, any system actually adopted should allow flexibility to meet the interests of particular counrties. Thus, there are certain products that the United States might wish to exempt from preferential treatment. Sweden might, for example, wish to exempt an entirely different group of products. Some nations might wish to base preferential treatment on some form of global quota system, related to domestic consumption or imports; others might wish to avoid quotas, and rely primarily on escape clause mechanisms. At the present stage of our knowledge concerning the effects of such alternative systems, it would be premature to insist that all nations adhere to one general preferential formula to the exclusion of all others. As Mr. Greenwald pointed out in his testimony here on

July 12, many complex issues of policy and administration remain to be worked out before the United States and other nations can reach agreement on an appropriate system of preferences.

If possible, however, a few common elements do seem desirable: (1) preferences should be given from all rich countries to all poor countries, with the definition of a poor country being left to the sole discretion of the applicant for preferential treatment (members of the Development Assistance Committee of OECD and hostile nations presumably excluded); (2) preferences should be temporary, preferably through the device of progressively lowering existing post-Kennedy Round tariffs down to the preferential level (this, in effect, is what the United Kingdom has been doing by its participation in the successive GATT rounds since 1947); (3) the system should have more than a token effect—it is one thing to exempt from preferential treatment those products for which poor countries are already competitive exporters, and quite another to exempt products for which preferences are likely to catalyze a potential competitiveness into an actual one.

It may well be asked whether preferences are not simply a particularly complicated way of offering to underdeveloped countries advantages that they might receive anyway from most-favored-nation reduction, as in the Kennedy Round. The answer, briefly, is no. First, on political grounds, the governments of underdeveloped countries believe that they are particularly disadvantaged in the international competition for the fast-growing world market for manufactured products. Most-favored-nation reductions clearly do little to mollify this view. Second, Kennedy Round tariff reductions appear to have been considerably larger for manufactured products of interest to rich countries than for those manufactured products that poor countries are presently or potentially capable of exporting. This fact simply reinforces poor countries' conviction that general trade liberalization is primarily a device for enriching the wealthy. Third, preferences can act as a stimulus to underdeveloped countries to look at the opportunities afforded by world trade, as a counterweight to their often costly and self-defeating preoccupation with the encouragement of import-substituting industry. The potential gains to both rich and poor countries are evident and potentially large.

Rich countries are often concerned with the balance-of-payments effects of their trade policies. It should be noted in this connection that the growth of LDC exports may well offer the United States certain potential balance-of-payments advantages under a general preferential system, particularly if that system is accompanied by other policy measures.

Expanding Trade and Investment Interests

This leads to the second major policy issue that I am raising today: Increasing the mutual interests of the United States and the underdeveloped countries in expanded trade and investment ties. In 1964 Mr. David Horowitz, governor of the Bank of Israel, proposed that rich countries guarantee the flotation of bonds in their capital markets, the proceeds to be used by an international agency, such as the World Bank, for relending to underdeveloped countries. He also sug-

gested that governments of the rich countries subsidize these loans by appropriating relatively modest amounts for interest subsidy, in recognition of the pressing debt service problems of many underedeveloped nations.

This scheme, as advanced by Governor Horowitz, suffered, in the U.S. view, from two cardinal defects. First, it was generally believed that most of the proposed borrowing would take place in the United States or Eurodollar markets, both of which are the primary current sources for U.S. domestic and foreign capital investment, as well as for the normal borrowings of the World Bank. Second, because the aid was to be administered by an international agency, it would presumably be untied, thereby possibly further aggravating America's balance-of-payments difficulties.

It is not necessary, however, to choose between endorsing the Horowitz proposal as originally advanced and rejecting the principle entirely. The Export-Import Bank of Washington, D.C. lends money to finance exports of American equipment abroad, largely to underdeveloped countries, at rates of interest which reflect the implicit U.S. Government guarantee involved. If the United States wants to maintain and enlarge its trade and investment ties with underdeveloped countries, it is free to authorize a similar institution to borrow funds directly in the U.S. market, to be relent to underdeveloped countries at terms and conditions that would depend on the present and prospective international solvency of the borrower. A modest interest subsidy fund appropriated by Congress could cover the differential between the Government guaranteed market borrowing rates and the lower rates that some underdeveloped countries could afford to pay.

This relending facility should, as long as the United States faces balance-of-payments problems, be tied to the purchase of American equipment.

In addition to building and perpetuating markets for American goods, such a device offers the additional advantage of linking the underdeveloped countries to U.S. capital markets. The Government of Mexico today, for example, borrows certain amounts annually in the New York market. As nations receiving these loans progressively develop their economies, the activities of such a proposed relending agency might be limited simply to guaranteeing bond issues of these countries without subsidy provision, and in the longer run, without intervention by the U.S. authorities.

Ultimately, of course, appropriations for foreign aid and bond issues floated in the New York market to be relent under subsidized interest rates, are simply alternative ways of tapping U.S. capital resources, although the latter method obviously encourages far more trade per dollar of appropriated funds. The method that I am now suggesting allows the tapping of capital markets to be done on the basis of mutual material advantage without the lengthy and, I suggest, frequently unprofitable process of annual congressional hearings, to say nothing of the great temptations faced by the foreign aid agency to allow relatively short term considerations to dominate the allocation of funds.

This is not to say that foreign aid is or should be devoid of short-term political goals or of regular congressional review. It should be a basic role of the foreign aid agency, under the general policy authority of the Department of State, to use foreign aid to further U.S. political interests as appropriate. But this is no reason to allow U.S. commercial interests in the economic development of underdeveloped countries to fall within the province of an agency whose dominant goals are necessarily and legitimately political.

Therefore, I suggest that the executive and legislative branches should seriously consider the establishment of an American development bank with authority to borrow in the market and relend at variable terms and conditions to underdeveloped countries in order to help them finance purchases of American equipment.

COMMODITY POLICY

The third matter on my list is commodity policy—international action to affect world trade in the food and raw materials produced and exported by underdeveloped countries. First, a few words about existing policies. The U.S. Government now follows a policy of examining, on a case-by-case basis, international commodity agreements aimed at stabilizing prices and, in effect, thereby raising the incomes of commodity exporting nations above the levels that would prevail in a free market.

These agreements are in some way similar to rich countries' policies for their own domestic agriculture. It is also the policy followed by unofficial agreement in world markets for such products as petroleum, aluminum and, to a lesser degree, copper. The U.S. currently participates in two official international commodity agreements: the International Coffee Agreement and the International Wheat Agreement. Tin and olive oil are also subject to international commodity agreements, to which the United States is not a signatory. Among products of primary interest to underdeveloped countries, only three other products can seriously be considered as likely candidates for international price fixing agreements: cocoa, tea, and sugar.

It is time, and I suggest long past time, that the United States agreed to an international cocoa agreement. We have been negotiating for 9 years, with negotiations regularly breaking up over trivial issues; 1 or 2 cents a pound difference in proposed floor prices; the size, financing and composition of buffer stocks, if any, et cetera. It may well be true, as Senator Long has said, that some commodity agreements are objectionable on the grounds that they transfer incomes from poor people in rich countries to rich people in poor countries. But, by and large this is not true of cocoa, which is produced mainly by small farmers in West Africa. Furthermore, free market cocoa prices fluctuate excessively from year to year, thereby making it almost impossible for a cocoa farmer to relationally plan his investment in new trees, spraying, fertilizing, et cetera. This fluctuation also increases the difficulties faced by governments of cocoa exporting countries in following a rational foreign exchange policy.

A world tea agreement is not necessary. There are only four major exporters: India, Ceylon, Tanzania, and Uganda. If the governments of these four nations choose to reach a price stabilizing agreement, there is nothing to prevent them; it is a very different case from that of the 40-odd countries that export cocoa.

Futhermore, most of the tea entering rich countries is imported by the United Kingdom, which would be unlikely to consent, voluntarily, to an international agreement raising the world price of tea.

An international sugar agreement is similarly unnecessary. Most of the world's sugar already moves at prices above those which would prevail in a free market, thanks to the special arrangement offered to exporters by the United States, EEC and the United Kingdom. The other major sugar importers, Canada, Japan and some of the other Western European countries are also free to offer premium prices to the countries whose sugar they normally buy. An international agreement today would be politically unacceptable because of the issues raised by marketing Cuba's supplies. If the Soviet Union or other countries wish to pay Cuba premium prices for its sugar, that is their concern—there is no reason for the United States to be involved in an international agreement which brings it no advantage and which creates difficulties in the international scene.

There are no other major commodities moving in world trade for which the price-fixing commodity agreements can be negotiated that will significantly benefit underdeveloped countries.

On the other hand, there is a considerable, and yet largely unexplored, potential for using commodity agreements as a device to promote efficient world production of commodities, using temporary subsidies to benefit those nations whose exports decline as a consequence of shifts in production.

I should point out that while that possibility would considerably increase world economic efficiency, our experience in these fields has not been in particular successful. If the United States were to go to underdeveloped countries and suggest that a more rational world order of commodity production be established, we would first have to put our own house in order.

Trade Policy Alternatives

Let me come to my fourth point, analysis of trade policy alternatives. As Mr. Baldwin said today in another connection, we don't know very much about the effects on production, trade, and balance of payments of the various policy alternatives that face the United States at the conclusion of the Kennedy Round. The U.S. Government has an opportunity over the next few years to support a detailed and searching analysis of the economic and political implications of various alternative trade policies, both singly and in combination. The decisions that the Congress and the Executive make in the next few years will have profound effects on a world trade level which is now approaching $200 billion annually. For an expenditure of not more than $1 or $2 million annually over the next few years, the United States could come to the conference table with a much sounder knowledge than it now has of the implications for itself and for other countries of specific economic policies.

Some of these issues that I have just discussed are too difficult to be resolved effectively by simple introspection. Other analytical issues cannot be resolved in the short run by any expenditures of funds, no matter how great, because the analytical tools have not yet been developed to cope with the problems. But in this age of the electronic computer, and with the constant improvement of data on production and trade, we are dealing in trade policy with issues whose results are too complicated to guess at, but in many cases not too complicated to analyze by detailed examination of data.

This analysis will cost money. I feel reasonably confident in saying that the return from such an investment might be among the most profitable investments Congress could have the wisdom to make in the field of foreign policy.

Thank you.

Chairman BOGGS. Thank you very much.

Mr. Witt, we will hear from you. And then the members of the committee will ask questions.

STATEMENT OF LAWRENCE W. WITT, PROFESSOR OF AGRICULTURAL ECONOMICS, MICHIGAN STATE UNIVERSITY

Mr. WITT. Mr. Chairman, and gentlemen, my special topic this morning is on agriculture. Each of the people before me has commented in some degree on agricultural problems. And I find that there is a bit of overlap, and I will refer to some of these comments, as I go along.

Most of my comments look beyond the Kennedy Round toward future international negotiations on trade restrictions and policies. The range for action in the agricultural arena is greatly limited by pressure from a variety of political forces that feel that trade policy is central to national policies for agriculture and for national development. In this case I am very close to the position with which Mr. Pincus started his testimony. To clarify this point, let us look at the developed and the developing nations separately.

Many developed nations use import restrictions or export assistance as devices to implement their particular farm policy. Trade restrictions are used by importing nations to increase the income to low income farmers and to provide equitable returns to agricultural resources. Subsidies by exporting nations seek to achieve the same objectives. For individual nations of Western Europe, 75 percent to nearly all farm commodities receive price benefits from such measures, in contrast to less than half in the United States. Instead, and in addition, the United States has used CCC purchases and storage, land retirement and direct payments to attain similar objectives.

Thus, in effect, the implied position of the United States in negotiating trade policy with developed nations, asks them to put the major share of their farm price policy on the negotiating table while putting only part of our policy into the discussion. Understandably, the agricultural leadership in the European developed nations feels that existing farm policy is threatened to a greater degree. They take political action to prevent change and to avoid the necessity for a long struggle to hammer out a new farm program. With 25 to 40 per-

cent of the voters in or close to agriculture, the strength of this political resistance is strong. The only solution, if there is one, requires that a basis be established for negotiating over the entire area of agricultural policy. Here I find myself saying much the same thing as Mr. Diebold said.

The hopes for agriculture in the Kennedy Round were not fully realized, primarily for this reason; namely, the political aversion to concessions that would require a reformulation of existing agricultural policy. Even so, some progress has been made. The commitment to supply a substantial quantity of grains as international food aid (thus subtracting them from European food supplies), coupled with rising incomes and shifts toward a greater consumption of animal products, on the part of European countries, will benefit the food and feed grain producers of Canada and the United States, despite the absence of major changes in European trade restrictions.

The political forces in the developing nations take on a different focus. Their national leaders understand well the importance of primary products as the major exports of these nations, and the vital role which exchange earnings play in national development. And they know that the developed nations are their major customers. Past instabilities in these markets, slow rates of growth in the demand for primary products, and fears that exchange earnings will continue to be inadequate, support a strong political approach among the developing nations toward the developed economies. The formation of UNCTAD (United Nations Conference on Trade and Development) in 1964, with its first conference in Geneva, provided a forum for the organization of new political forces in the world trade arena that will not be easily satisfied. Professor Baldwin has also commented in this vein. While we and Western Europe might agree among ourselves that certain exceptions to free trade that discriminate in favor of our national producers are politically necessary, the developing nations press for instant removal of all discriminations against them. And more, they press for discrimination in their favor and against the production and exports of developed nations. And in fact they would not object if there were discrimination against domestic producers in the developed nations.

These political pressures from developing nations will intensify with the 1968 UNCTAD Conference in India; thus a second reason for looking beyond the Kennedy Round into our foreign policy area.

I turn now to summarize quickly the more specific economic material in the study paper prepared for this committee. Agricultural products constitute over 20 percent of U.S. exports, and nearly a third of the total world trade. For most developing nations, agricultural and other primary products dominate their export picture.

While the volume of agricultural trade is expanding, it is declining as a proportion of the total. Thus, trade does not provide a reliable engine of economic development. Growth is hindered by basic characteristics of demand and by policies. With higher incomes, food absorbs a smaller share of the added income. Also, the policies of developed countries support domestic production at the expense of imports, and thus limit the potential exports of agricultural nations. The resulting complex leads to international markets without consistent rules and with conflict increasingly focused on agriculture.

Let me turn for a moment to ii of our study paper. Developing countries face special problems because of price instability and advanced country policies. The nature of the demand for agricultural products exposes these commodities to fairly wide price fluctuations, which leads to government intervention to influence the market, such as minimum export prices, domestic price supports, subsidies to export, marketing boards, and international commodity agreements. In technical terms, this basic characteristic is a low elasticity of demand with respect to price; that is, a small increase in volume brings a larger decrease in the price received. This traditional concept has been less valid during the past decade, primarily because of the increased ability of major consuming nations to maintain economic stability, but still is important. In consequence, the less developed countries, as they examine their agricultural trade potentials, hesitate to expand most farm exports greatly. Although some have done so successfully, most nations fear that larger volumes of exports will lead to lower prices and lower foreign exchange earnings. This point is more telling when the Nation provides a significant fraction of the total world trade in its principal export commodity.

Consequently, the developing nations argue that: (1) they are discriminated against in favor of the domestic producer of competing products; (2) their exports are subject to substantial price instabilities; and (3) their most logical industries face especially high rates of protection which force them to export raw materials and to turn to import substitution industries. Neither of these is an optimum solution in terms of economic logic and comparative advantage, for them or for us. In our paper we give an example showing that a modest tariff of 5 percent on raw materials and 15 percent on processed goods, becomes a 35-percent protection for the importing nations processing industry.

Mr. Cooper has already touched on this, and also Mr. Pincus.

I have already suggested that the trade prospects are favorable for the export of red meat and feed grains to most developed nations. Some shifts in patterns of trade will occur if membership in the EEC is expanded, or if new regional groupings develop.

The population—food supply problem is a prominent feature of the developing countries. The problem stems primarily from the accelerated rates of population growth, which overwhelm the very creditable increases in food production occurring in many of the developing nations. Concessional exports will be required for some time to come. A substantial program of family planning can influence the need for a food aid program after 1980, but the potential heavy consumers of concessional food aid during the 1970's are already born. Without population control, the "need" for food aid will increase continuously.

The relation of trade and domestic interests is becoming evermore comprehensive and interrelated. The United States has a complex pattern of interests in agricultural trade. This interest includes but goes far beyond the economic interest in a large volume of exports. It includes trade from developing countries as a partial substitute for foreign aid. It includes the support which growth in trade can make to improved economic welfare of people around the world. It includes

the economic welfare of U.S. farmers and marketing agencies who produce and distribute for the export market. It includes the simple humanitarian interest in making bread, rice, and better nutrition more possible than before. These and more are elements of the broad U.S. interest in agricultural trade.

These interests continue to present the United States with major challenges and opportunities for policy leadership. Our efforts should seek to increase the competitive structure of world markets and at the same time to encourage cooperation among nations in dealing with food aid and the trading problems of less developed countries. Exploration of appropriate policies and possibilities for coordinated international action needs to continue on such important issues as: (1) methods of reducing the conflict between domestic agricultural policy and international trade policy, (2) provision and financing of all aid including food aid, (3) preferential trading relations and reduction of barriers on imports from developing countries, (4) financial arrangements and marketing aids to permit expanded trade and improved export possibilities for developing countries, and (5) the purpose and role of international commodity arrangements in future improvement of international agricultural markets. Because of timing, it is especially important that we, with other developed nations, prepare a realistic, coordinated policy position before the 1968 UNCTAD Conference in India.

Thank you.

Chairman BOGGS. Thank you very much, Mr. Pincus.

We will begin the questioning with Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Cooper, you point out the link between trade policy and monetary reform, in that the existance of the new international monetary medium makes it possible to finance balance-of-payments deficits longer than would otherwise be the case, and hence yields less of a temptation to adopt restrictive trade devices. I think that is a point you are making on the second to the last page. In that connection, we note in this morning's paper that the meeting of the Ministers in London on international monetary reform has currently broken up without any substantial agreement having been reached. I gather that what must have happened was that the French maintained their insistence on some kinds of a drawing right with a fairly harsh repayment provision, so that it really didn't even come close to constituting an international asset. And our negotiators, I gather, must have stuck—properly—to our position, that unless there was something approaching a new international monetary medium which the central bank would be willing to hold, any agreement would be illusory.

I now come to my question. In your judgment, is the United States well advised to stick to its guns, or would it be in our interest to sign any kind of agreement just for the sake of having an agreement at an international monetary meeting?

Mr. COOPER. I was very disheartened by what I read in the paper this morning about the lack of agreement among the finance Ministers on international monetary reform. From what I know of the European, which I guess is the French, position on the monetary reform, I would not recommend accepting it just for the sake of agreement. Countries are going to be faced with balance-of-pay-

ments difficulties from time to time. The purpose of reserves or international lines of credit is to permit countries to finance these occasional balance-of-payments deficits without having to do violation to their other objectives, both national and international.

I do not fear a repetition of the 1929 debacle. Most Western governments are sufficiently committed to their domestic economic objectives to carry through with action to prevent a deep depression. The real threat I see in severe balance-of-payment deficits is precisely to the areas that we have been talking about this morning, trade policies. Deficits which cannot be financed, and about which there is a sufficient uncertainty that a change in exchange rate seems inappropriate are likely to be stopped by interferrence with trade and other international transactions.

I see no reason to think that forces leading to imbalance of payments are likely to diminish in the future. On the contrary, they will perhaps increase, for a number of reasons. It will therefore be necessary to have an adequate flow of new international reserves to permit financing of larger and more prolonged deficits. I don't mean by this that I see a perpetual deficit for the United States. I am talking about the international payments system as a whole. And Countries need larger reserves to finance these deficits and to feel comfortable about doing it; that is, they must feel free to use those reserves rather than modify their policies to defend reserves.

As I understand the French position on monetary reform, it would do very little to provide that kind of financing. I would say even that a straightforward increase in IMF quotas such as we had in 1965, with mitigation of gold subscriptions, would be preferable, and should not be denigrated.

Representative REUSS. Mr. Pincus, you've made a suggestion in your paper which I quote: "The executive and legislative branches should seriously consider the establishment of an American development bank with authority to borrow in the market at variable terms and conditions to underdeveloped countries in order to help them finance purchases of American equipment." I think that is a good idea. However, don't we have such an institution—the Export-Import Bank—which lately, it turns out, has been getting into antics not having to do with development? That to the side, the Export-Import Bank does have the power to go to the market with participation certificates—maybe not enough from our standpoint, but it does have that power. It can relend at variable terms and conditions—maybe not as much as you have in mind, but, of course, it can charge a 7-percent interest rate on some loans, and then use the money it gets to be able to charge a 2 or 5 percent interest rate. And to the degree that it does, it may be the wrong people and the wrong commodities. And finally, it is restricted, of course, to financing purchases of American equipment. So, why couldn't the Export-Import Bank, with maybe a few refinements substantially be what you have in mind?

I suspect it could.

Mr. PINCUS. I suspect it could, also.

The kind of thing I have in mind would involve some annual or biannual appropriation of the interest subsidy, because I am thinking of larger sums of money than the Export-Import Bank is now operat-

ing with. And there is a certain international competition among export credit agencies, which is in effect what the Export-Import Bank is—a long-term supplier of export credits.

I feel that the Export-Import Bank's potential has been greatly underrated by people who concern themselves with the welfare and development of the underdeveloped countries, because there is a tendency to feel that it is nothing but a device for selling American merchandise abroad. What I am saying is that I think it should have much greater flexibility. As a realistic matter, flexibility would have to include much longer terms. In some cases, for the poorer countries, the interest rate would have to approach zero. This means that an interest subsidy would have to be appropriated. The Export-Import Bank could not go to one country and say, you will have to pay 12 percent to compensate for the low rate we are charging another borrower. The answer would be, no, we will get our export credits elsewhere, at rates lower than 12 percent.

I think that in trying to do something to ameliorate the economic conditions of underdeveloped countries, however much one might wish it could be so, Congress or other departments cannot do it solely on the basis of considerations divorced from the U.S. material interest. What lubricates trade is the coincidence of material interest. I am saying that some of these countries are so poor now that that lubrication process is going to take a long time, and cost the United States a certain amount of money. In my personal opinion, it is going to take much more money than the Export-Import Bank now has at its disposal, and it is going to take some form of interest subsidy which would be even larger than that implicit in the present operations of the Export-Import Bank. I believe on the other hand to have the foreign aid agency do it, opens up a series of vistas that I find impalatable for the economic development of those countries, and also quite possibly for the interest of the United States, in that short term considerations might then tend to dominate.

Representative REUSS. Thank you.

Chairman BOGGS. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Pincus, do you draw any distinction between rich countries with a balance-of-payments deficit and rich countries with a balance-of-payments surplus?

Mr. PINCUS. In this testimony I have said that as long as the United States has a balance-of-payments problem, the Export-Import Bank, or some revision of it, should tie the loans. I think that the struggle to achieve untied aid in the international arena is fruitless. I think every major trading nation is mercantilist. If it has a balance-of-payments surplus, it wants to keep it. If it doesn't have one, it wants to get it. By simple arithmetic we have to recognize that that is impossible.

However, we do have a balance-of-payments deficit for reasons that obviously take us too far afield to discuss now. I see no reason whatsoever why we should not follow the same policies followed by Western European nations who are doing the same things, extending tied export credits, and nonetheless maintaining a fairly substantial balance of payments of surpluses. We have no leverage that we are will-

ing to exercise to force them to change their policies. I don't see why we shouldn't follow the same policies ourselves. It is the coincidence of material interests that lubricates economic activity.

Senator MILLER. So, the preferences from a rich national with a balance-of-payments deficit should be the same as the preference extended by a rich nation with a balance-of-payments surplus, is that your position?

Mr. PINCUS. No, that is not my position. What I say is that a country with a balance-of-payments deficit should look, among other factors at the balance of payments influence on it of the preferential systems it chooses to adopt. And you can make your preferences by product in such a way as to affect your balance of payments, you can do it by recipient nation in such a way as to affect your balance of payments; you can do it by escape clauses and quotas; and you can do it by many devices that we haven't yet considered.

I think, in essence, the principal point I have made in this testimony is that the Government is perfectly willing to go into negotiations that involve billions and billions of dollars of trade annually, but is not willing to spend a few million dollars a year on electronic computers to find out what the various of balance of payments implications of alternative trading systems are. That is the concern of Congress. It just seems to me to be extraordinarily shortsighted.

Senator MILLER. The reason that prompted my question was your— was where you said preferences should be given from all rich countries to all poor countries. But you didn't necessarily mean that identical preferences should be given, that this should be within the framework of trying to cope with the balance-of-payments deficit on the one hand, or the balance-of-payments surplus on the other.

Mr. PINCUS. That is what my testimony states.

Senator MILLER. Now, to carry that a step further, should these preferences be the same for poor nations with a balance-of-payments surplus as for poor nations with a balance-of-payments deficit?

Mr. PINCUS. Poor nations with a balance-of-payments surplus are a problem that has worried the foreign aid agency in recent times, because it was pointed out to AID, look, you are giving money to countries which are building up their foreign exchange reserves. Now, that to me is not a convincing argument. I am sure one could devise a method to keep all underdeveloped countries' foreign exchange reserves at zero, but I don't see the utility of it. They are not building them up because of some desire to have money in the bank rather than develop the country. These things can be cyclical. One year the price of coffee is high, and at another time it is low.

Senator MILLER. In that case, there would be no distinction that you would make on the preferences?

Mr. PINCUS. I don't see any undeveloped country that I know of— unless you look to Kuwait as a less developed country—which is regularly building up a balance-of-payments surplus.

Senator MILLER. In considering preferences for an undeveloped country, shouldn't one of the factors be its balance-of-payments situation?

Mr. PINCUS. Not in my opinion.

Senator MILLER. Mr. Cooper, you testified as follows: Restrictions

on imports are obviously suitable if the balance-of-payments deficit is not expected to last. That is, the currency should be devalued.

Are you thinking of any particular countries with respect to this devaluation?

Mr. COOPER. No.

Senator MILLER. Do you have any examples?

Mr. COOPER. No. There are many historical examples. If a country is facing a serious balance-of-payments deficit, and if there is just nothing in the cards so far as anyone can see to reduce it in the foreseeable future, then that is a prima facie evidence that the country is in "structural disequilibrium" to use the term in the IMF articles of agreement. Under the IMF rules, that country ought to change the parity of its currency. That is the accepted solution for such a disequilibrium.

Senator MILLER. I am not denying the validity of your statement. But I am pointing out that it might be difficult to apply. I was wondering if you had any countries you would want to name where that point should be applied?

Mr. COOPER. I wouldn't want to name any country where it should be applied now. There are historical examples. The French franc in 1955–1957 was in fundamental disequilibrium. It was devalued in 1957 and again in 1958, but perhaps devalued too much.

Senator MILLER. It may be embarrassing for the United States or any nation to suggest to one of these other nations that they should devalue their currency because things are hopeless.

Mr. COOPER. It has been done, but not publicly. The IMF holds discreet conversations with all of its members.

Senator MILLER. Now, I would like to ask any of you gentlemen at the table if you know how important this American selling price problem is to the Common Market countries? Does anybody have a comment on that? I know that you didn't particularly cover it, but would you like to make a comment on how important to the Common Market the American selling price is?

Mr. BALDWIN. I don't know the exact trade figures, but we know, of course, that the Germans are very much interested in it. They feel that it is important for them, and that if it were removed, they would be abel to increase their exports of chemical products considerably.

Senator MILLER. Is it important to France, too, do you know?

Mr. BALDWIN. I am not sure of that. I know it is the Germans who are pushing the hardest. I imagine there are some chemical products affected by ASP coming from most of the Common Market countries.

Mr. DIEBOLD. I think Switzerland and Britain have an interest in it, too.

Senator MILLER. Thank you very much.

Mr. Witt, you stated: "The commitment to supply a substantial quantity of grains and international food aid (thus subtracting), will benefit the food and feed grain producers of Canada and the United States." We had testimony from Mr. Roth, the other day, that this food aid share on the Common Market would amount to about a million tons a year.

Mr. WITT. I thought it was a total of four and a half million tons.

Senator MILLER. Well, from the Common Market it would be a million tons. Now, my concern is mainly with the Common Market. And what you in effect are saying is that the Common Market

is putting up a million tons of food aid, and this will subtract from the Common Market food supply, and therefore give us a better opportunity for exports. But only 2 or 3 days ago there was an article in the New York Times indicating that the Common Market had decided to increase their support prices for domestic produced grains, and the forecast was that they would substantially increase their production. So, I question whether this will, in fact, subtract from their market.

Mr. WITT. Senator Miller, the question here is: What are we comparing? Is this new price policy a direct consequence of the Kennedy Round negotiation, or would it have come anyway? Which shall be the basis for comparison? But more important, the food that we are discussing is in part denatured and fed to livestock, from France in particular, as reduced internal barriers facilitate flows into other parts of the European Common Market And a certain amount has been subsidized and exported into other parts of the world. Since Europe produces much soft wheat, it is not possible to use it all, and it has been necessary to import high protein wheat to prepare the kind of flour that is needed.

Now in the present situation, with this new agreement we substract a million tons, to be distributed through something like a food-for-progress program on some kind of basis to the developing countries. It is not in Europe to feed to livestock, and it is not there to mix in with the other wheat, and produce flours for the population.

However, if there is in the present or future a deliberate policy on the part of the European countries to increase their food production and their wheat production so as to provide this extra wheat which they are committed to providing for distribution to the rest of the world, to that extent, of course, it is contrary to what I am suggesting here.

If you will permit me, Mr. Chairman, I will be glad to extend my remarks on this matter in a subsequent submission for the record.

Chairman BOGGS. Without objection, you have permission.

(Material subsequently filed by Professor Witt appears below:)

MICHIGAN STATE UNIVERSITY,
East Lansing, Mich., July 24, 1967.

Hon. HALE BOGGS,
Joint Economic Committee, Congress of the United States,
Washington, D.C.

DEAR MR. BOGGS: This letter is a further response to Senator Miller's question at the Hearings last Wednesday, and represents a request to respond to your invitation to extend our remarks.

Professor Sorenson, who worked with me in preparing the study paper, provided me with the enclosed statement on the questions posed by Senator Miller, namely: will the price changes by the EEC lead to a net increase in grains production? You will note from 8 that no net increase is anticipated, but that some shifts in trade may occur This could mean a smaller rate of increase in North American exports to the EEC but greater opportunity elsewhere.

Very truly yours,

LAWRENCE W. WITT.

EXTENSION OF REMARKS OF LAWRENCE W. WITT

The following statement dated June 27, 1967 prepared by George E. Rossmiller is added to comment further on the questions raised by Senator Miller. It is based on research materials developed in a Michigan State University-U.S. Department of Agriculture Project on the EEC, under the direction of Vernon Sorenson and Dale E. Hathaway.

EEC PRICE STRUCTURE CHANGE ANALYSIS

With a change in the EEC price structure as follows, what factors play a part in determining production and consumption shifts and what are the estimated magnitudes of these shifts?

Price changes:

Barley, from $91.25/ton to $96.00/ton.
Corn, from $90.63/ton to $99.00/ton.
Beef, from $66.25/100 kg. to $70.00/100 kg.
Pork, from (?)/100 kg. to $73.50/100 kg. (increase).

1. The effect of these price changes taken together is to raise the price structure of livestock products and feed grains absolutely and relative to wheat. We can say this because beef and dairy products are jointly produced and the feed grain price will influence poultry meat and egg prices. Thus production changes are possible due to relative price changes and consumption changes are possible due both to the rise in price relative to the total economy and the relative shifts within the agriculture price structure.

2. Due to (1) the inflexible farm structure and, (2) a partially offsetting increase in the price of beef (a forage using enterprise) no shift is envisioned as between grain and forage or other crops. Thus the price changes will not affect total grain surface.

3. Some shift into barley from other feed grains, particularly oats, is to be expected. This will be less than one might first expect due to limits, at least in the short run, on the crop rotation pattern and the already rapid rate of decrease in oats and rye surface. But to the extent this shift occurs, projected feed grain production will increase by an amount equal to the difference in barley or corn yields and the yields of those crops they replace times the amount of surface shifted in this manner. Some shift from wheat to barley surface is probable, with a resulting increase in total feed grain production but with an offsetting decrease in wheat production.

4. The price of corn has increased not only relative to other grains but to barley price as well. So from a price point of view pressure exists to shift to corn production even over barley. In practice the direct effect on corn production will be very small because corn surface is already being expanded as rapidly as capital (irrigation in Italy and France) can be provided and varieties can be improved and adapted to soil and climatic conditions. Corn yields in the marginal areas are highly variable due to yearly weather fluctuations and the relatively small change in the barley-corn price ratio is not enough to bring about more than a negligible surface shift from barley to corn. Thus, no change in projected total feed grain production is seen from this source.

5. The increased price of feed grains will have some effect on production in the livestock sector, particularly in those livestock enterprises which must purchase their feed. But so will the price increase for beef and the newly established base price and intervention mechanism for pork. Since the feed grain price is a variable in the formula determining the sluice gate price and import levy for poultry meat and eggs, the sluice-gate price will increase. The poultry meat-feedgrain and egg-feedgrain price ratios will remain about constant so no significant shift in the production trend is probable for these products. The net effect of the barley, corn, and pork price increases is an *increase* in the pork-feed grain ratio. We can expect a surplus situation in pork production. The rate of feed grain use for cattle may decrease slightly. Thus the net feed grain utilization effect, *disregarding for the moment consumption considerations*, will be (1) no change in requirements for poultry meat and eggs, (2) increased requirements for pork, (3) partially offset by decreased requirements for cattle.

6. On the consumption side, a generally higher price will tend to slow the growth in consumption of meat. Since the price of pork will rise relative to poultry, some shift to consumption of poultry at the expense of pork can be envisioned. Beef demand will probably increase consisent with earlier projections since an upward beef price trend was assumed. Increased prices for pork and poultry were not assumed for earlier projections. Thus in net the beef deficit will remain largely unchanged from the projections. The potential pork surplus will be aggravated by the consumption effects of the price structure change. To the extent that demand shifts toward poultry, greater feed grain utilization in the sector will occur. (Modifying conclusion in point 5 above.)

7. This leaves the effect which may well be the most important of all—the possible shift of wheat from export to feed channels. With an increase in feed grain prices relative to the wheat price, wheat becomes a stronger competitor in the feed grain market. Two main factors must be considered in production and one with respect to transportation. The transport question revolves around whether it now becomes more profitable to move wheat from wheat surplus areas (mainly the Paris Basin) to feed grain deficit areas (mainly Netherlands, Northern Germany, and the Po Valley) within the EEC than to import feed grain directly from third country sources. The production questions include (1) will the mix of grain produced and fed on farms include a higher portion of wheat and, (2) to what extent will the mix of feed grain moving in commercial channels shift toward a higher portion of wheat.

The feed mix from farm produced grain will probably not shift significantly since a high portion of wheat is already contained in farm produced feed grain mixes. (In Germany, only 60% of wheat produced in 1964/65 moved through commercial marketing channels—a high proportion of the remainder presumably was fed on the farm.) With respect to locally mixed commercial feed, some shifts in mix to a higher wheat portion may occur, If the change in price ratios is great enough to make movement of wheat to feed deficit areas more profitable than importing from third countries a substantial diversion of export wheat into feed uses can occur.

8. Analysis of effects. We see no change in projected feed grain production levels due to points 2 and 4 above. The effects discussed under point 3 above will result in an increase from the projections of not more than 1 million tons additional feed grain production by 1970, with next year's product shift from these sources being substantially less.

The consumption effects of point 6 coupled with the livestock production effects of point 5 will increase utilization of feed grain by probably at least an equal amount. Thus the effects of points 5 and 6 will cancel those of point 3 leaving the net feed grain production-utilization balance largely unchanged.

The unanswered question, and as indicated above the one of potentially greatest importance, is whether a major diversion of surplus wheat from export to feed use occurs. Some diversion can occur locally, but unless large quantities of surplus French wheat are denatured and shipped to Northern EEC and/or the Po Valley, the implications for U.S. exports should not be great. Whether this diversion will occur can be answered only through direct discussion with trade and EEC officials in Europe who buy grain and compute feed manufacturing costs related to surplus disposal. The price at which surplus wheat can be sold in world markets, as well as internal EEC prices and transport costs will influence the outcome.

If the pork support policy stands and is effective, we expect this to lead to substantial and burdensome pork surpluses. Further, a rise in pork prices causing a demand shift to poultry may create a short term spurt in poultry imports until domestic (EEC) production adjusts. Finally it is doubtful that the policy will stand without further changes because of the additional pressures created by the probable beef deficit and pork surplus.

Source material.—MSU-USDA Project on EEC. Reports by Sorenson, Hathaway, Rossmiller, Mangum, Epp, and Petit.

Senator MILLER. Thank you very much. My time is up.

Chairman BOGGS. Senator Javits?

Senator JAVITS. Gentlemen, I will not detain you very long. I would like to know, first, what is your opinion as to giving up the most-favored-nation principle in order to make the necessary deals with the less-developed countries?

We might start out with Professor Cooper.

Mr. COOPER. It depends on what you mean by giving MFN up in principle. I stated in my testimony that I think the best outcome for the United States, and indeed for the world, would be carrying on with the trade negotiations of the broad-gaged Kennedy Round type, that is, within the MFN context. Personally I would not object to the idea of so-called advance cuts in that context, that is, if we have be-

fore us a period of say, 10 years of trade liberalization on an MFN basis, but phased over time so that the tariff cuts come in small increments, I can see some argument for extending those cuts at once to the less-developed countries. I think that one should not exaggerate the gains from that, and recognize what it really is. It would, in effect, be transferring foreign aid through commodities, with the selection of recipient countries taking place through the market rather than through the foreign aid agency. Nonetheless, in a period as long as 10 years that might stimulate some investment in some less-developed countries. Of far greater importance than preferences in advanced countries' markets are improvements in the tariff structure of the advanced countries. There is much what we might call anecdotal evidence that processing industries are excluded from less-developed countries because of the tariff structure in advanced countries. As a result, they export raw material in a relatively unfinished state.

But this change in tariff structure can be brought about by general across-the-board reduction in tariffs; preferences are not necessary for that.

To sum up, I wouldn't mind breaking temporarily from the MFN principle in the form of advance cuts, but only in a clearly defined context of across-the-board MFN tariff reductions among all industrial countries.

Senator JAVITS. Any other comments?

Mr. Witt?

Mr. WITT. I think I would say essentially the same thing. It is much more important to look at the commodities and the tariff structure here than to look at easing up on—giving them special preferences. They obtain preferences if you deal in commodities that are important to them, without violating the most-favored-nation clause. The recent trade agreements involved many commodities that were of interest to the developed nations. And one of the objections that some of the developing countries are making—whether true or not is another question—is that we have negotiated enough on the commodities that are of major interest today to the developing nations. And we can do a great deal this way.

Senator JAVITS. Mr. Baldwin?

Mr. BALDWIN. I would like to go along with Mr. Cooper on this. I certainly would support the notion of an advance cut of the Kennedy Round tariff reductions to the less developed countries. I also think that we should be quite skeptical about the merits of preferences. It seems to me you inevitably get into the kind of problems that Senator Miller raises and that these will lead to an elaborate system of quotas, not just tariff quotas, but quantitative restrictions among the developed countries and among the less developed countries. Are you going to treat every developed country the same regardless of whether the country has a deficit or not? Or are you going to treat every underdeveloped country the same? Should you treat India the same as some African country, for instance, Kenya? Of course, if you do, India is going to get much more of the benefits from generalized preferences or manufactures. And should the degree of preferences for India differ from the preferences to the developing countries, depending upon the level of development and the balance-of-payments situation? You could also

establish different quotas for each individual commodity. After a while I think you would get into an extremely elaborate system of quotas that will be difficult to administer, and that would lead to increasingly bitter haggling among the developed countries and the less-developed countries. I think, as in the case of the cotton textile agreement, there would be a severe backlash of ill feeling against the United States.

I don't think in the long run it is going to help the less developed countries more than a moderate amount. The problem just isn't one of simply granting small preferences. This growth difficulty arises to a considerable extent from their own elaborate import substitution policies that many countries are undertaking to an excessive degree and which results in excess capacity and high prices on commodities that could be export products, in an attempt to handle their expansion of exports themselves.

We also have some evidence that the Commonwealth preferential system, which was introduced in the early 1930's, did not have much effect on commodities where the tariffs were not too high—as will be the case for many commodities at the ed of the Kennedy Round. We have also found in that experience that the effects were rapidly dissipated. By the end of the 1930's non-Commonwealth countries had caught up and restored their historical shares in the British market.

Thus, I think we are going to get all the drawbacks in terms of the political backlash, and yet not any great economic benefits.

Another point I want to make is that it will begin, I think, to lead to the destruction of our whole principle of free multilateral trade. As you get these quota arrangements applied to less developed countries, you are certainly going to get pressures in the United States to apply them against other developed countries. Why shouldn't you apply a quota against Japanese goods and not just Indian goods? In the long run the less developed countries are going to suffer because of type of extension of quantitative restrictions.

Senator JAVITS. Would the answers be any different if we talked about abandoning the MFN principle with a Latin American Common Market on the same theory that the European Economic Community gives preferences to the former associated countries?

Mr. BALDWIN. I don't think it would make much difference.

Senator JAVITS. It would be the same?

Mr. BALDWIN. These special regional preferences are actually worse than the general ones.

Mr. DIEBOLD. Most of what I originally intended to say was said by Mr. Baldwin and Mr. Cooper. I share very much their view on the preference issue generally. I won't repeat what they have said, but I think there is a problem in the approach that Mr. Pincus was suggesting, because I find a conflict in tendency between some of the things he said.

On the one hand he said we ought to be flexible so that countries could exclude from the preferences those things that they wished to. The aim is to get more done than if we insisted that the United States and every one else do the same thing. I think that is an attractively realistic idea in many ways. But my fear is that, particularly in the case of preferences, it would be one more element in the kind of erosion

Mr. Baldwin was talking about, because each one would not only do what was easiest for him, but he would tend to ask a special quid pro quo, which would tend to make the whole system a complicated one in which the advanced countries would in effect, if not always in form, be looking for special preferences in the undeveloped countries. Indeed, the Common Market did that in their agreement with Nigeria, something I think we should have objected to more strongly than we did.

The other weakness of the flexible approach, it seems to me, is that would be one more factor making the preferences less valuable to the developed countries than people would like to think. It is precisely at the places where important trade gains could be made that preferences will not be given because of competition with the domestic producers.

But I would like to go back to the point that you started with, Senator Javits, leaving aside now the merits or demerits of preferences. If for whatever reason, political or otherwise, the United States were to go into some form of preferential arrangement for some or all less-developed countries, I think we should not think of it as "abandoning MFN." We should think of it rather as a controlled departure from the principle of the most-favored-nation. And if this sounds cynical, I can only suggest that we have had such a controlled departure in the case of Western Europe during the dollar shortage. There were a lot of people in this country that thought that GATT and the ITO were really frauds because the exceptions were more important than the rule. Those exceptions permitted people in balance-of-payments difficulties to discriminate against us primarily. But if we had not had the basic agreement on the equal treatment principle, we should now still be trying to get back some of the things that we got automatically from 1958 on when European currencies became convertible. I would think that any experiments in preferences for less-developed countries, on a hemispheric basis or otherwise, ought to be subject to the other side of what Mr. Pincus talked about, which was the stress on certain broad principles of generality, of temporary limitation, and things of that sort. I think under such rules one can reduce the risk of complete erosion and destruction of the world trading system and a better control the departure from the principle of equality.

Senator JAVITS. Mr. Pincus, do you want to get into this, too?

Mr. PINCUS. I think that the remarks made by the other witnesses today are quite correct, by and large. I am simply approaching it from a slightly different viewpoint. I think Mr. Diebold's comments are correct in talking about the control of departures from MFN. The point about quotas made by Mr. Baldwin is ill taken. Those are tariff-free quotas. They are not quotas as to the total amount of imports that one takes. In other words, 10 percent of what you send me I will allow in duty free, but that doesn't mean that I stop importing the rest at the MFN rate. So, I don't see the relevance of his point.

The second point that I would make is that the preferences offered by advanced countries to underdeveloped countries are by their very nature not going to allow changes in the system of world trade, because domestic producers in the rich countries don't want vast changes made in the domestic structure of production.

Therefore, any system, any preferential system adopted will necessarily be limited in its effect. My arguments for it are essentially two, and I think they are basically political, although phrased in economic terms. One is that I believe that a series of preferential systems are in the cards. Now, if the United States wants to stand back from that, it is their privilege. I just happened to think it is a poor idea to stand back from it.

The preferences system actually adopted by the OECD countries in concert or separately will certainly be such as to have a rather small impact on the actual structure of the production in the developed countries, but they may have the very important effect of doing exactly what some of the earlier speakers said, turning these people's eyes away from high cost import substitution and toward the fact that there is a world market in which they now have at least some feelings as being the victims of discrimination.

Senator JAVITS. Now, to followup that, is that your prescription for the optimum proposition you can offer UNCTAD, what you have just stated?

Mr. PINCUS. On this matter, you mean?

Senator JAVITS. That is what UNCTAD is all about.

Mr. PINCUS. It is about other things. It is about commodities agreements and supplementary finances, the whole bunch of things.

Senator JAVITS. Let's stay on this matter.

Mr. PINCUS. I think I can answer it a little indirectly. One could say to the UNCTAD countries, no preferences. That is what we said in 1964.

Senator JAVITS. Go ahead.

Mr. PINCUS. In 1964 we said we were willing to study the subject. And we studied it. In the spring of 1967 at Punta del Este statements were made that implied a change in our position, I believe. I certainly took the inference that the U.S. Government would back some kind of a general preference system. And this is our present stance in our OECD discussions with other rich countries.

Now, I think from what little I understand of the political economies of most countries, that such a system has two purposes. One is to give the underdeveloped countries not only something that they want, but something that may actually have a beneficial effect on their world economic view.

The second is to do a minimum of "damage" to the interests of the domestic producers in the developed countries. In order to do that, you have to walk a tightrope.

Now, if you are asking me whether walking that tightrope is the only likely stance I can think of in the preferential line, the answer is "Yes."

Senator JAVITS. Gentlemen, just one other question. What do you think of these commodity agreements? Do you like them, or don't you like them?

Now, we have got a new one now coming up as of the result of the Kennedy Round. And there are others being negotiated. On the whole, have they performed, and do you favor this as a policy of the United States?

Mr. WITT. Senator Javits, we have some experience with the predecessors of the commodity agreements, and with a number of commodity agreements. And out of this history most people who examine it decide that the consuming nations, exporting nations, both should be involved, at least if it is an important product. And in this respect I part company with what Mr. Pincus said in his testimony about letting the tea countries get together and exploit Great Britain's tea consumption to the extent that they can. Our experience with the existing commodity agreements on the whole is not very satisfactory. It has solved some short run problems. We find that many people still look at commodity agreements as having potential, whereas they look at exactly the same principle applied in domestic agriculture by the United States and a number of other countries as failures; yet they want to use international commodity agreements on an international basis with much less control of production, over the flow of the commodities. We become very sophisticated on many of the difficulties of wheat programs, corn programs, cotton programs, tobacco programs in the United States. And yet suggest that perhaps international commodity agreements can solve similar surplus problems on the international level. In fact, it is extremely difficult for a less-developed country to go as far as we have been able to go in having some control over production. If a commodity agreement is going to be effective, it means that you must have some influence on both the supply and the demand of the commodity. If you fail to control the supply, you create stocks, you create the necessity for some secondary disposal programs, or the agreement eventually will break down. An effective commodity agreement calls for a good deal more sophistication in management than is feasible in many cases.

So, I think that many people's hopes for these programs are simply not borne out by the practicability of actual operations, except as a short-term solution to a particular problem of price instability under unusual circumstances.

Senator JAVITS. Any other comments?

Professor Cooper?

Mr. COOPER. I would just like to comment briefly on your question about UNCTAD.

I believe that the United States should not feel that it has to go to UNCTAD with a proposal giving preferences. I know there is a feeling that when there is a big international conference, the United States traditionally is expected to take the initiative in those areas, and very often does. I also feel that UNCTAD has been a very useful organization for bringing into public focus many of the problems of the less-developed countries. But I do not think that we should be dragooned for so-called political reasons into policies that we think are not sensible. The political gains, that is, the psychological gains, the Brownie points that we get from such proposals, will be very short lived. We are not going to make friends forever by coming forward with preference proposals in UNCTAD. If it doesn't make sense on its merits or it isn't in our long-term interests, it seems to me we should not feel obliged to put forward some kind of preference arrangement merely in order to appear forthcoming in an international conference.

Chairman BOGGS. Gentlemen, unfortunately, our time is up. The House is in session. I would like to thank each of you for coming. And if any of you care to elaborate on your remarks this morning we would be happy to add the additional material to the record.

Senator JAVITS. Mr. Chairman, may I join with the Chair in thanking the panel. I have rarely seen a more gifted panel. I was just riveted to my seat all morning, although I have a million other things to do. I thank them.

Chairman BOGGS. I agree with you, they are most learned. We are very happy to have had them with us.

We will meet tomorrow at 10 o'clock, when we will hear David Rockefeller, president, Chase Manhattan Bank, and George W. Ball, former Under Secretary of State.

(Whereupon, at 12:15 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Thursday, July 20, 1967.)

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