Summer 1-1-2009

The EU's Protectionism Problem

Meredith Kolsky Lewis

University at Buffalo School of Law

The EU's Protectionism Problem

Meredith Kolsky Lewis

Meredith Kolsky Lewis is a senior lecturer of international trade law at Victoria University of Wellington.

Major economies are reacting to the global financial crisis with a number of similar strategies, including fiscal stimulus packages, corporate bailouts, and increased protectionism. Many world leaders, such as President Barack Obama and former European Trade Commissioner Peter Mandelson, are decrying protectionism and calling for markets to remain open. However, evidence of increased protectionism abounds in multiple guises, including escalating use of anti-dumping duties and countervailing measures, economic bailouts of strategic domestic industries and financial services providers, and incentives to buy locally manufactured or grown products.

This is not surprising. In times of economic difficulty, protectionist measures tend to increase. But if it is widely acknowledged that protectionism will ultimately cause more harm than good to both individual national economies and the global economy, why is it so common? This paradoxical behavior is not limited to the context of economic crisis. Trade negotiations frame trade-liberalizing measures in terms of "concessions" rather than opportunities. For the majority of trade deals, leaders and government representatives must fight numerous political battles to sell the agreements at home.

This article examines the risks of increased protectionism and explains why countries nonetheless resort to protectionist measures, focusing on recent developments in the EU.

In particular, it argues that while protectionism is harmful to an economy as a whole, the interest groups that benefit from protectionism are often more effective lobbyists than those that are harmed by the protectionist measures. However, the WTO assists its members in guarding against those producers who seek protectionism. This defense is particularly crucial now as protectionist measures are, and will continue to be, on the rise as a result of the global financial crisis and contracting world economy. Examples, particularly from the EU, will be used to demonstrate the tensions between policies at a federal level (or in the case of the EU, union-wide) and the interests of subgroups such as subregional interests, or national interests in the case of the EU. The article concludes by stressing the dangers for Europe of failing to re-engage and conclude the WTO's Doha round of trade negotiations.

Although the EU is a highly integrated customs union, it is not immune to internal political pressure.

Interest Groups and Producer Bargaining Power. Despite the obvious harm to consumers, producers manage to obtain protection for themselves because they tend to be far better organized than consumers. In his important work on collective action, Mancur Olson noted that as a result of the ability of relatively small groups to organize themselves to act in their own common interests, special interest groups wield disproportionate power in society.[1] Olson also noted that large groups such as consumers and taxpayers tend not to organize themselves to advocate for their common interests, which adds to the imbalance.[2] Many industries have trade associations, unions, and other organizational structures that provide a forum to exchange information and develop strategies of mutual interest. Producers are therefore in a position to form powerful lobbies which can then seek government protection. Politicians may perceive more pressure to respond to issues raised by well-organized, visible producer interest groups than to act for the benefit of largely silent consumers. Agricultural interests in the EU and manufacturing industries such as steel and automotives in the United States are prime examples of this.

An illustration of this phenomenon is the EU's Common Agricultural Policy (CAP). The EU devotes close to half of its annual budget to the CAP, which provides extensive support to a discrete and well-organized group, European farmers. The CAP was originally designed in the early 1960s to reduce Europe's reliance on imported food. The CAP system of price supports, subsidies, and other payments, coupled with high tariffs on imports, ultimately resulted in vastly increased agricultural production far exceeding domestic needs and led to so-called "butter mountains," "milk lakes," and similar stockpiles of other foodstuffs. Export subsidies have also led to increased production and have enabled some of the surplus supply to be sold competitively on the world market. The CAP has been subject to intense criticism worldwide (as have been forms of U.S. agricultural support), with many condemning the assistance for inefficient first-world farmers at the expense of agricultural interests in the developing world.

In addition, EU leadership has sought to rein in the CAP due to its drain on the EU budget. While reform of the CAP has been underway for some time, progress is difficult. As described above, the inefficient farmers that benefit most from the CAP—particularly in France but also elsewhere—protest vociferously whenever cuts in their support are debated. While EU consumers would benefit from more open markets and the EU as a whole would benefit financially by eliminating the costly support programs, the benefits would be comparatively small on an individual basis relative to the losses that would be suffered by the producers. Therefore, it is an ongoing struggle to overcome the objections of the CAP recipients and further reduce the support provided. Agriculture has played a major role in the troubled—and now stalled—WTO Doha round of trade negotiations, with EU and U.S. farming interests pushing their governments to make as few concessions as possible.

Europe's Competing Interests.

Although the EU is a highly integrated customs union, it is not immune to internal political pressures. On the contrary, the union has a double layer of self-interested parties to contend with: the first is the agricultural and other producer interest groups within the various member states and the second is the governments of the individual nation-states to whom those producers are raising their demands for protection. Thus, today we see that EU member countries are increasingly responding to the economic downturn by acting in their own interests rather than that of the EU common market.

There have been overtures to domestic consumers to buy domestic products. For example, in the relatively liberal United Kingdom, there is much rhetoric in the supermarket sector advocating buying locally grown items and contemplating labeling on the basis of "food miles."[3] Even more strongly in Ireland, Minister of Finance Brian Lenihan beseeched Irish citizens to do their "patriotic duty" by shopping in-country rather than in Northern Ireland.[4] EU member states have also focused on strengthening home producers at the expense of larger EU economic and trade integration. French President Nicolas Sarkozy recently proposed a 6-billion-euro bailout of the French auto industry. In February he said, "if we are to give financial assistance to the auto industry, we don't want to see another factory being moved to the Czech Republic."[5] Germany has also sought to protect its auto industry, cutting non-wage labor costs on several occasions with the intent of preventing outsourcing and keeping factories in the country.[6] Germany has had in effect for a number of years the controversial "VW law" which ensures that the German state of Niedersachsen can retain its stake in the Volkswagen auto manufacturer.[7] In Italy, Prime Minister

Silvio Berlusconi suggested that if an Italian company, Indesit, abandoned plans to relocate to Poland, it would be eligible to receive a piece of a 2-billion-euro state-aid rebate program.[8]

In contrast to these national leaders, the EU leadership is speaking out against protectionism and rejecting some calls for significant bailouts of national industries. Current EU President and Czech Prime Minister Mirek Topolánek has decried the protectionist actions of member states, warning that

> If big countries continue to behave in a protectionist way, they will only repeat the scenario of the 1930s...The response of the eurozone countries to the financial and economic crisis deformed the joint project of the euro more than any other imaginable event. Most of the national states using the euro started breaking the common rules by their declarations as well as by practical steps, while the basic anchor of the whole process is to adhere to these common rules.[9]

Thus, Europe is experiencing tension between entrenched local interest groups and those who set policy for the union as a whole. This tension leads to what can be described as a prisoner's dilemma. Any given country would likely agree that its citizens will benefit more if its trading partners' markets are open rather than closed. However, any given country may also recognize that the best scenario would be for its trading partners' markets to be open while it provides protection to its own producers. Unfortunately this kind of thinking, while eminently rational, will in the aggregate lead to the inefficient result of all countries protecting their own markets. This helps to explain why at the national level governments sometimes succumb to the temptation to provide assistance in the form of protectionism to domestic industries, and it also illustrates why international disciplines on protectionism are necessary.

By virtue of having joined the WTO and become subject to its rules, members have changed the payoff structure such that it is no longer as tempting to be protectionist because there are negative consequences to so doing. In particular, the WTO provides disciplines that limit members' ability to impose certain types of protectionist measures. However, the WTO rules can be financially costly and politically difficult for members to enforce against one another. This reality, and the fact that the Doha round negotiations have stalled, has led some countries to push the envelope in terms of protectionism, particularly given the economic downturn.

The temptation to engage in protectionism also exists in the context of free trade agreements and customs unions. Studies of regional integration in models of endogenous protection demonstrate that the shift to preferential trading leads to a concomitant increase in protection against those outside the trading area.[10] Indeed, despite Topolánek's anti-protectionist stance, the EU itself has occasionally succumbed to the temptation to have its cake and eat it too by providing protection domestically while taking advantage of markets that remain open elsewhere. The EU leadership announced earlier this year that it was reinstating an export refund program for European dairy farmers that had been suspended two years ago. While termed an "export refund," the program is essentially an export subsidy in that it provides payments to farmers that are conditional on exporting.

Export subsidies are considered to be the most trade-distorting of all forms of agricultural support measures because they fundamentally alter comparative advantage. When producers receive payments that are tied to their export activities they naturally elect to increase their level of exports in order to receive the subsidy. The payments lower the farmers' costs of production and therefore permit them to sell at lower prices overseas than they would otherwise be able to. Producers in other countries who would be able to produce more efficiently and sell more cheaply than competitors in the absence of export subsidies now find themselves losing market share and receiving lower prices due to the influx of subsidized exports.

Agricultural export subsidies are particularly problematic because they have been employed historically by wealthy countries at the direct expense of agricultural sectors in developing countries. Agreement has been reached in the WTO's Doha round of trade negotiations to phase out all agricultural export subsidies over a multi-year period following the conclusion of negotiations. However, because the Doha round is a so-called "single undertaking," members are not bound to any interim agreements reached. Instead, there will be no formal, binding agreement on any new liberalization measures until all of the negotiations have been concluded in the form of a completed round. Thus agricultural export subsidies are still permitted for now, though they are subject to disciplines set out in the WTO Agreement on Agriculture and the Agreement on Subsidies and Countervailing Measures.

Whether or not the EU's reinstated export subsidies breach the letter of these agreements is unclear; however, they unquestionably violate the spirit of the Doha round negotiations. New Zealand and Australia, both of which export dairy products without resorting to subsidies, reacted swiftly and sharply to the EU's actions.[11] New Zealand Trade Minister Tim Groser registered his concerns with European officials, including European Trade Commissioner Baroness Catherine Ashton and European Commissioner for Agriculture and Rural Development Mariann Fischer Boel:

> I related our desire to see an early end to the recently reintroduced EU dairy export subsidies and of the growing concerns...that the EU action could lead to an escalation of trade protection. I also reminded ministerial counterparts...that G20 and APEC leaders last year had explicitly directed

Europe is experiencing tension between entrenched local interest groups and those who set policy for the union as a whole.

> Trade Ministers to conclude the Doha Round of trade talks and not to resort to protectionist measures during the economic crisis.[12]

WTO Director-General Pascal Lamy has also warned against a return to beggar-thy-neighbor policies: "There is another spectre lurking in the mist which could make this already bad situation even worse—the threat of a return to the isolationist policies of the 1930s."[13]

Given that the European leadership is well aware of the dangers of resorting to protectionism in the current economic climate, and has even denounced the protectionist measures of member states, it is a bad sign for global economic prospects to see the EU backsliding and reinstating one of the most pernicious forms of support available. It illustrates mounting tensions between the EU leadership and its single Europe objectives, and the increasingly nationalistic concerns and demands of the member states. At times it may seem politically necessary to provide relief on an EU-wide basis, if only to forestall member states taking matters into their own hands.

Conclusion. Tim Groser, Pascal Lamy, and Mirek Topolánek are correct in their assessments. Protectionist actions will only lead other countries to respond with their own market-closing measures, which will deepen recessionary trends. Governments that are implementing fiscal stimulus packages are doing the right thing; the global economy needs to be spurred to produce more, not less, and the way to accomplish this is to provide incentives for growth and consumption. In this context, it would be highly beneficial to restart the Doha round negotiations and find a path towards an agreement. The EU benefits significantly from the market access and rules-based disciplines the WTO provides. The best way to assist European economies will be, as elsewhere, to open up markets overseas to provide more access for European products.

Nonetheless, the EU has its work cut out for it. Individual members have fierce interests in protecting domestic constituencies—particularly the highly subsidized agricultural sector—from further liberalization. The EU leadership will have to combat pressures emanating from individual members, however, or the future will become even bleaker. The longer that the Doha round languishes, the more members will continue their pursuit of free trade agreements and other selective trading arrangements.

While the EU is itself a very large and growing customs union, it may not fare as well long-term if individual free trade agreements overtake the WTO in relevance. The United States has engaged in preliminary negotiations to join the Transpacific Strategic Economic Partnership Agreement (TPP), which currently comprises New Zealand, Singapore, Brunei, and Chile. Australia, Vietnam, and Peru will also be a part of these negotiations if they resume.[14] Resuming and advancing the negotiations would represent a savvy move on the part of the United States to gain a foothold into, and to help shape, the agreement that is likely to serve as the catalyst for a much wider Asia-Pacific free trade area. If the United States and Asia join, Europe may be the odd man out. With this prospect looming, even distantly, Europe would do well to take the necessary steps to help get Doha going again. Getting the member states to buy into this plan, however, may prove exceedingly difficult.

NOTES

1 Mancur Olson, Jr., *The Logic of Collective Action* (Cambridge: Harvard University Press, 1965), 127-128.

2 Ibid., 165.

3 "Food miles" refers to the distance food has traveled from farm to plate.

4 Jamie Smyth, "Economic Crisis and Protectionism Threaten EU's Single Market," *Irish Times*, 17 February 2009.

5 Wolfgang Muenchau, "Europe's Protectionism Trap," *Business Week*, 16 February 2009.

6 Ibid.

7 Daniel Kramb, "Protectionism Rolls Through Europe," *The European Magazine*, Internet, http://www.cafebabel.com/eng/article/1725/protectionism-rolls-through-Europe.html (date accessed: 4 October 2006).

8 Smyth, "Economic Crisis and Protectionism Threaten EU's Single Market."

9 "EU Heavyweights Warned against Protectionism," *EurActiv.com: EU News, Policy Positions, and EU Actors*, Internet, www.euractiv.com (date accessed: 10 February 2009).

10 See Arvind Panagariya and Ronald Findlay, "Political-Economy Analysis of Free-Trade Areas and Customs Unions" in Robert C. Feenstra, Gene M. Grossman, and Douglas A. Irwin, eds., *The Political Economy of Trade Policy: Papers in Honor of Jagdish Bhagwati* (Cambridge: MIT Press, 1996), 283.

11 New Zealand Trade Minister Tim Groser, Press Release, "EU Dairy Export Subsidies Disappointing," Internet, http://beehive.govt.nz/release/eu+dairy+export+subsidies+disappointing+0 (date accessed: 16 January 2009).

12 New Zealand Trade Minister Tim Groser, Press Release, "Trade Minister Expresses Strong Concerns over EU Dairy Subsidies," Internet, http://beehive.govt.nz/release/trade+minister+expresses+strong+concerns+over+eu+dairy+subsidies (date accessed: 5 February 2009).

13 Smyth, "Economic Crisis and Protectionism Threaten EU's Single Market."

14 The Obama administration has recently sought to delay all pending FTA negotiations. This is presumably merely to allow time to formulate policy and it is anticipated that the TPP discussions will resume.