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The Theory of Trade Discrimination: The Mirror Image of Vinerian Preference Theory?

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THE THEORY OF TRADE DISCRIMINATION: THE MIRROR IMAGE OF VINERIAN PREFERENCE THEORY?

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This paper contains preliminary findings from research work still in progress and should not be quoted without approval of the authour.

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Since Viner's classic Theory of Customs Unions, there has been a great deal of analysis of what happens when two (or more) countries form a customs union--or, more generally, when each provides the other with preference in its domestic market. However, little or no attention has been paid to the problem of what happens when one country discriminates against another, rather than providing it with favourable preference.

The immediate intuition is that, since these two policies are the mirror image of each other, they will have mirror image effects as well. But this is not so: in some respects their effects are opposite; but in some other important respects, their effects are the same.

Analyzing trade discrimination is of interest and importance not only because of this theoretical parallel to the Viner problem, but also because of its important current policy implications: For example, the Europeans have long contended that discrimination against imports from specific countries provides a better safeguard measure than non-discriminatory import curbs. Although this position has in the past been contested by the U.S., this same discriminatory philosophy has recently surfaced in the U.S., with the proposals before Congress (such as the Danforth bill) for "aggressive reciprocity." It will be shown that the damage such a policy could do to the U.S. is apparently not fully understood, either by Americans, or more surprisingly, by the Japanese who are generally regarded as the likely target.

Suppose that the U.S. imposes a tariff against Japanese goods only. While there may be no resulting change in trade patterns, with the U.S. simply buying less from Japan, we concentrate on the more complicated case where there is diversion (defined simply as a switching of U.S. purchases away from the original least cost source--Japan--to a third source--say Europe). The reason for this "discriminatory diversion" parallels Viner's earlier "preferential diversion": Although Japan remains the lowest cost source of supply, Americans making the purchasing decision buy the good more cheaply from the Europeans who are able to escape the U.S. tariff imposed on the Japanese.[1] Because the U.S. is no longer importing from least-cost source Japan, this policy of discrimination results in a U.S. terms-of-trade loss--the same sort of loss that arises from a policy of preference. Thus these two U.S. mirror image policies do not, as expected, have mirror image effects on the terms of trade. Instead, both discriminatory diversion and preferential diversion have the same negative effect on the terms of trade. The reason is that <u>any</u> diversion--wheter it be in response to preferences or discrimination--will switch import purchases away from the least cost source.

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[1]In the case of a quota, discriminatory diversion occurs in the transparent case when Americans who can't buy Japanese goods because of the quota, buy from Europe instead.

However, the two mirror-image policies do have the expected opposite efficiency effects. Whereas preferential diversion results in a U.S. efficiency gain in production and consumption because the reduced U.S. trade barrier allows the American domestic price to <u>fall</u> towards the world price, discriminatory diversion results in an efficiency loss because the increased trade barrier <u>raises</u> the U.S. domestic price. This theory of discrimination can be illustrated most transparently in a simple diagram such as Figure 1.

Also note that the basic ambiguity that arises in analyzing preferential diversion (how does the efficiency gain compare to the terms-of-trade loss?) does not arise in the case of discriminatory diversion (where an efficiency <u>loss</u> unambiguously augments the terms of trade loss).

This theory has an important policy implication: Ask the average trade negotiator how the U.S. terms of trade will be affected if the U.S. increases its tariff on Japanese goods and the reply is likely to be: "Favourably; it's the optimal tariff argument again--a tariff improves a large country's terms of trade, right?" Maybe right, maybe wrong. "Right," if the pattern of trade doesn't change; then the U.S. will continue to buy from Japan, and it will be at more favourable terms of trade. But "wrong" if U.S. trade is diverted from Japan to a higher cost source, in which case the U.S. terms of trade will deteriorate.

Surprising that the Japanese haven't pointed this out to the Americans: While U.S. discriminatory diversion (as, for example, might result from a U.S. policy of aggressive reciprocity) will indeed hurt the Japanese, it will also damage the Americans, who will incur terms of trade and efficiency losses. Consequently, the benefit of this policy to the U.S. would not be realized if the policy is actually introduced, but only if it is threatened, and the threat succeeds in reducing Japanese trade barriers. Thus if aggressive reciprocity diverts trade, we can put it in the exclusive and paradoxical category of policies that offer benefits only so long as they are not actually imposed.[2]

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[2] True a non-discriminatory U.S. tariff increase may fall in this category too. But its less likely to, since its likely to generate some terms of trade improvement rather than loss. ~~For more detail on aggressive reciprocity, see Cline or Wonnacott.~~

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