

THE CLASH BETWEEN ECONOMICS AND POLITICS IN THE WORLD TRADE ORGANIZATION

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I. INTRODUCTION

The collapse of the world trading system and global economy in the 1930s was a nightmare for all who lived through it. Economists and policy makers recognized the fact that each country, acting in its own self-interest, had achieved nothing and indeed made things worse. “Beggars-neighbor” policies, as they came to be called, were put in place to devalue currencies and raise tariffs against the rest of the world in the hope that import substitution and greater export attractiveness at lower domestic prices would increase employment in the tariff-increasing and/or devaluing country. But since other countries’ governments retaliated by raising their own walls of protection and devaluing, whatever was gained on the import-competing side was more than offset by losses of exports and higher costs of the import-competing goods.

At the end of the Second World War, technocratic policy makers, especially in the United States of America (USA) and United Kingdom (UK), were charged with designing a postwar international economic system designed to avoid a repetition of the disastrous 1930s. Because political attention was focused on the war and immediate postwar reconstruction, these policy makers – including John Maynard Keynes, Lionel Robbins and James Meade, among others – had much more

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latitude than is usually the case as they approached the international economic architecture for the postwar period.

The proposed postwar international economic institutions – the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (now called the World Bank), and the International Trade Organization (ITO) – were designed with the experience of the 1930s vividly in mind. Thus, the IMF was intended to provide coordination on exchange rates so that there could be no more competitive devaluations: countries would maintain fixed exchange rates except in cases of “fundamental disequilibrium” and change to a new fixed exchange rate only with the agreement of the Fund. The World Bank was designed to permit capital to flow from low–return to high–return countries, as it was assumed that after the 1930s the world would not witness a resumption of long term private capital flows (which was at least partly correct until the 1990s) and that an efficient international economic allocation of capital would not result from private sector initiatives.

The ITO was intended to meet two objectives. On one hand, all recognized that an open multilateral international trading system was in everyone’s interest and should be restored. On the other hand, in light of the experience of the 1930s, it was generally believed that full employment should be an objective of economic policy and could be achieved only by resort to government macroeconomic policies.

These two objectives were viewed as somewhat in conflict, as it was thought that a country might experience recession with high unemployment because of large imports and might be justified in imposing trade barriers in order to increase employment and output. Today, it is recognized that macroeconomic policies and conditions in labor markets are the determinants of the level of employment, and that conditions in the trade sector at most can have a short–run impact on employment. Countercyclical macroeconomic policies are obviously desirable, but do not include trade policy.

But that is ahead of the story. The charter for the proposed ITO sought to reconcile these two objectives by describing the appropriate policies that countries should follow in normal circumstances – these policies, when implemented, would result in something approaching the economist’s ideal of an open multilateral trading system. The first half of the articles in the proposed charter in effect spelled out rules governing trade policy (tariffs, nontariff barriers, etc.) to be followed at full employment. The other part of the draft focused on exceptions countries might make in times of less than full employment. It was envisaged that countries might temporarily impose or heighten protectionist measures when trade flows were deemed to conflict with the full employment objective.¹

This second part of the proposed Articles was much in keeping with the thinking of the times. However, it was rightly objected by many that the “full employment exceptions” in the second part were so all-encompassing that a country could do whatever it wanted in the name of achieving full employment. As such, there would be no international discipline to prevent a return to the ‘beggar thy neighbor’ policies of the 1930s.

While these apparent contradictions were being debated in anticipation of a Havana Conference to finalize the text of the ITO articles, conditions in much of the world in the immediate postwar period were dire, especially in Europe and Japan. War-devastated countries were confronted with limited productive capacity and excess demand for imports, not only for food but also for capital goods to enable reconstruction. Because the USA had escaped all this, a “dollar shortage” was the order of the day. European countries (and many others) resorted

¹ It was recognized that a country might use exchange rate policy to maintain a rate which resulted in a current account surplus; the draft of the ITO articles and the GATT stipulated that the IMF should play a major role in judging the appropriateness of exchange rates and prevent the use of exchange rates for purposes of “beggaring neighbors”. There was also a provision that a currency could be designated “scarce,” in which case other countries could resort to protection against imports from the scarce currency country. The provision was never formally invoked. For a concise account of the ITO and GATT drafting, see Dam (1970:10-16).

to high levels of protection and quantitative restrictions on imports. In addition, there were bilateral clearing arrangements among the European countries under which imports were to balance exports country-by-country. These measures were appropriately viewed as an obstacle to the postwar reconstruction effort and certainly as a source of inefficiency in the world economy.

Opening up the trading system was therefore seen as of first order importance by many, including especially American policy makers.² To that end, they proposed a first round of trade negotiations for an open multilateral trading system prior to the Havana Conference and the passage of the ITO charter. To achieve this, most of the proposed articles that dealt with the desirable trading system, assuming no unemployment concerns, were to be implemented quickly, to be followed by a negotiating session to achieve some reciprocal reduction of tariffs.³

The General Agreement on Tariffs and Trade (the GATT) – the “liberal part” of the ITO proposal – was therefore inaugurated, in the case of the USA by executive decree, and other nations followed suit. The GATT, expected to be temporary, was provided with a small secretariat in Geneva to handle the necessary mechanics of a first round of trade negotiations.

As they say, “the rest is history.” The ITO charter was never ratified, and the GATT continued, not as an international organization, but as an “agreement” until the 1990s when it was folded in to the World Trade

² As is well known, the United States also adopted the Marshall Plan, under which it provided financial support for recipient countries. As a condition of receiving these resources, European countries were obliged to negotiate multilateral payments arrangements, first among themselves, and then more generally. Thus, most of Europe’s bilateral clearing arrangements had expired by the mid 1950s.

³ The GATT was implemented by executive decree in the United States, since the President was unable to obtain Senate ratification of the Articles. The President’s authority to negotiate reciprocal tariff reductions was scheduled to end prior to the Havana Conference, and the American authorities were anxious to use the authority to achieve some reduction in trade barriers prior to its expiry. It was anticipated that the ITO would later come into effect, including the GATT “liberal trade” part within its articles.

Organization (WTO). But even in the WTO, the GATT articles remain as they were initially agreed: parts have been added on, but the basic trade structure remains.

The GATT was enormously successful. At the time of the first Geneva conference, it is estimated that the average tariff level among industrial countries on manufactured goods was above 45 percent, and, as already mentioned, there were also numerous nontariff barriers to trade. Services were virtually not traded, and agricultural commodities were in such short supply that importers were happy to get them. So the initial focus of the GATT was, naturally, on tariffs on manufactured goods. The average tariff rate imposed by developed countries on import manufactures fell to just over 3 percent by 2000.⁴ Most of the nontariff barriers were completely eliminated so that, for manufactures, protection by 2000 consisted almost entirely of tariffs and was relatively low, especially among industrial countries. The growth of world trade has been a major stimulus to world economic growth which, over the past half century, has been more rapid than ever before over such a long period.

This phenomenal success has led to a host of new problems. At the same time, the very success of the GATT/WTO, along with technical changes enabling better and cheaper transport and communication, has led to a world with greatly increased awareness of globalization, and an inclination to blame that globalization for perceived economic ills in individual countries. One result has been weakened support for the open

⁴ Protection for agriculture was limited: in countries devastated by the war, efforts were made to increase agricultural production, but in the meantime, imports were vital and not initially highly protected. That changed over time, and, as protection against manufactured imports fell, that against agricultural goods increased (both by tariffs and by non-tariff barriers to trade and non-border measures) so that distortions in agricultural trade today far outweigh those remaining in manufactures. The USA, however, insisted upon “grandfathering” protection for agriculture in the GATT, so that it could continue with its support programs that had been developed in the 1930s. However, as noted by Dam (1970:257), “It would be difficult to conclude that the GATT’s record in the sphere of temperate agricultural commodities is other than one of failure.”

multilateral trading system and the WTO. That in turn has contributed to the failure, to date, of the Doha Round of trade negotiations to reach a satisfactory conclusion.

In this paper, I argue that a significant part of the problem is the clash between good economics and politics. A starting point is the GATT/WTO principles. Thereafter, the consistency of those principles and the acknowledged exceptions to them are evaluated. In that light, the paper ends with an assessment of the way forward for the world economy and the international trading system.

II. THE GATT/WTO PRINCIPLES

The GATT articles themselves consisted of the initial “rules of the game” such as nondiscrimination among trading partners, conditions under which there could be preferential trading arrangements, and the like. Subsequently, agreements have been reached on a number of issues (such as customs valuation and criteria for phytosanitary restrictions). The GATT was expected to do two things: first, to enforce the rules in the Articles (and also to enforce any subsequent agreements among members) and to adjudicate trade disputes arising out of negotiated agreements, and second, to provide the locus for negotiations for reductions in trade barriers.

As to the rules of the game, all signatories agreed to a set of principles by which they would abide. The principles of the GATT articles were relatively simple and straightforward. They were basically five: there was to be nondiscrimination among all countries so that if a country had a positive external tariff on a good, all its trading partners would be subject to the same protection. This might be called multilateralism, and is implied by the condition that each country have a “most-favored-nation” (MFN) clause in its trading agreements with all trading partners (who are signatories to the GATT, or, more recently, members of the WTO). Second, there were to be enforceable commitments – that is, once

countries had agreed to a given rule or negotiated tariff reduction, failure to observe the rule would result in penalties. Third, there was to be transparency, which meant that the measures countries take to protect their domestic industries should be visible and readily ascertained. This meant, in particular, that protection should occur through tariffs and not through quantitative restrictions on imports or other measures where protection is not obvious.⁵

The fourth and fifth principles are less consistent with economists' understanding of the benefits of an open multilateral trading system. The fourth is the principle of reciprocity, by which was/is meant that countries reducing their protection should receive reciprocal reductions from their trading partners. The fifth is that there should be a safety valve, so that should a reduction in protection negotiated through GATT result in a sufficient increase in imports to cause severe dislocation, the importing country could take measures to limit imports to reduce the hardship.

The second, and quite different, role of the GATT/WTO was to serve as a forum in which members could bargain "reciprocally" for cuts in their protection levels (which, according to the principles, were to consist solely of tariffs). Members extended tariff "concessions" (i.e. reductions) to other countries in return for reduced tariffs confronting exporters on their goods of interest. Since all signatories were bound by MFN under the GATT, mechanisms had to be found to "balance" individual countries' concessions. Once an agreement was reached, countries "bound" their tariffs at least until the next round of negotiations (and unless the

⁵ There have been a number of GATT/WTO agreements and protocols over this. For example, countries were sometimes thought to use health and safety restrictions as an excuse to prevent or restrict imports of food, drugs, and other items. But a GATT understanding mandates that health and safety regulations (phytosanitary restrictions) must be based on scientific evidence: it is not adequate to say that imports of a particular fruit do not meet requirements: it must be demonstrated that there is a safety issue that scientists will attest. But many other non-tariff barriers to trade have lacked transparency: the famous Poitiers case comes to mind, in which the French authorities decreed that all televisions imported into France had to enter through the port of Poitiers and be individually inspected. Poitiers is a very small port and there was one customs inspector.

safeguard exception was invoked). Countries were free to lower their tariffs below the bound rates, but not to raise them above those levels.

Implicit in the GATT agreement was the dual role envisaged for the GATT. It was a negotiating forum and an enforcer. Enforcement was to be concerned not only with the provisions of the GATT articles, but also with the bound tariffs and negotiated rules.

III. ECONOMICS VERSUS POLITICS

It is the “concession” framework of the GATT/WTO negotiations that the first, and biggest, clash between economics and politics occurs. Economists have shown that in most circumstances, countries that lower the protection they accord to their domestic industries benefit by so doing. Yet, in the GATT/WTO, lowering a trade barrier is regarded as something a country does because “it gets something in return,” i.e. the reciprocal reduction in the trade barriers facing the country’s exports. On the other hand, for political scientists, the genius of the GATT is that the trade negotiations bring exporters’ interests to the process (as trade officials are bargaining for reduced tariffs abroad) as an offset to the pressure that import-competing producers are bound to exert to try to avoid any reduction in the protection which they receive. Having exporters pressuring for acceptance of a negotiated, multilateral reduction in trade barriers enables trade negotiators to resist much more of the pressure import-competing interests exert.

The clash between economics and politics has clouded discussions of a number of issues in the GATT/WTO from the outset and has come more and more to the fore over time. In the remainder of this paper, some of these issues are discussed. They include preferential trading arrangements, the “free ride” given to developing countries in early rounds of negotiations, the preferences given to developing countries’ exports despite the GATT/WTO articles’ commitment to

nondiscrimination, and sectoral free trade agreements. The conflict also is a factor in the Doha Round and the role of agricultural protection.

Before turning directly to the issues, a background question must be addressed (even if an entirely satisfactory answer cannot be given). That is, why, if free trade is economically beneficial to the nation as a whole, does politics within countries prevent it? Economists have long puzzled over this. It is readily demonstrated that, in the absence of monopoly power in trade, there are always policies that can achieve desired objectives with more gain and lower cost to society than trade interventions.⁶ For years, it was concluded that people simply “did not understand.” But the persistence of protectionist pressures and measures suggests that the politics of trade are based on phenomena other than ignorance.

Economists recognize that there will be losers from moves to free trade at least in the short run, but point out that the winners could always compensate the losers and still be better off than they are with protection. Within countries, it is certainly possible to establish policies so that the gainers could compensate the losers: trade adjustment assistance (whereby laid-off workers are supported while they enroll in technical training courses or given benefits additional to normal unemployment insurance) could be tailored to do the job.⁷ But, in fact,

⁶ Since most countries have little or no monopoly power in trade, and trade restrictions are seldom imposed on the grounds of taking advantage of monopoly power in trade, I leave aside the issue of monopoly power except to note that if all countries had, and tried to use, monopoly power in trade, the world would be worse off than if all removed their protection. Retaliation by trading partners would offset much, if not more than all, of any gain individual countries might achieve. Hence, for large countries, the GATT/WTO serves as a guarantor that there will not be a “trade war” in which large countries would try to use their monopoly power in trade and other countries retaliate. For small countries, the assurance of equal treatment may be equally, if not more, important.

⁷ There are, or should be, important questions concerning why citizens’ whose jobs were eliminated due to trade liberalization should be treated any differently than others whose jobs are lost. Even prior to that, however, is the equally important question as to how one might ascertain which jobs were lost due to trade liberalization, and which lost for other reasons (such as technical change and shifts in consumer preferences).

opposition to reduction of trade barriers is strong, and stronger than one would expect given the overall gains to economies.⁸

One partial answer to the puzzle is that those who benefit from protection (producers of import-substituting goods) are concentrated, they know who they are, and can lobby effectively, while those who lose (consumers) are diffused and have difficulty knowing how to organize and may not find it worth their while given the small magnitudes of each individual consumer's gains. This was the answer given by Mancur Olson (1965) in his classic explanation of the puzzle.

While this obviously explains part of the puzzle, it overlooks the fact that when protection is greatly reduced, new economic enterprises will spring up to produce exportable goods, and existing exporting industries will expand. The gainers (including workers) will be concentrated in these new and expanded firms. It is not evident that these gainers will be any less concentrated than the losers. But since they are not already in firms or industries that will evidently benefit, they are not organized and cannot be organized (because identities are unknown) to support trade liberalization. The unemployed worker cannot know that if protection were reduced or eliminated, that exchange rate and other changes would render profitable expansion of a firm that might then hire him!

But the most frequently given answer for failure to adopt free trade has to do with time horizons: if a country removes its trade barriers, some will be harmed in the short run. Many of the short-term losers can be expected to gain over the longer run, but they will nonetheless oppose lowering or removal of trade protection (and support increases in protection when they can). In part, this is a result of identity bias: all of those working in import-substitution industries believe that they are

⁸ There is also the question as to why "job losses" attributed to foreign competition are such a prominent and visible factor in some political discussions. Most estimates of job losses "due to trade" in the USA, for example, suggest that trade can account for at most 20 percent of those losses. Meanwhile, the "churn" in jobs in the USA makes those losses a very small fraction of total job turnover.

threatened with job loss or reduced income if protection were to be reduced even if in fact only a fraction of those dependent on the sector will be so affected; at the same time, those who will benefit from expansion of exports (and from establishment of new firms in the expanding exportable sector) do not know that they will so benefit. Hence, more will oppose tariff reductions than will in fact be hurt (even in the short run) while fewer will support trade liberalization than will in fact gain.⁹ This, in a way, is an extension and elaboration of the “concentration” argument discussed above.

Another, and probably very important, part of the answer has to do with the existence of lobbies. Grossman and Helpman (2002) have shown how various groups will lobby politicians to gain favorable (protection for themselves or reduced protection of other industries depending on the group) treatment for their activities. Producers will support (and lobby) politicians who in turn will vote additional protection.

It is probably some variant of the Grossman–Helpman model that the framers of the GATT/WTO had in mind in the 1940s. For to speak in terms of “concessions” when a country reduces its tariffs is certainly not consistent with the proposition that free trade is the best policy for individual countries.¹⁰ But, if in fact the political power of import–substituting producers is very strong and there is some asymmetry in information and identity bias, the political rationale for WTO negotiations makes eminent sense: once producers of exportables know that they will benefit by the opening of foreign markets if it is negotiated, they may exert counterpressure on politicians and lobby for tariff reductions.

It is on this political rationale that the reciprocity principle in the GATT/WTO makes sense. And, judging by the reductions in trade barriers since the founding of the GATT, it must be judged that the

⁹ See Krueger (1990) and Fernandez and Rodrik (1991) for an elaboration of this argument.

¹⁰ It is interesting, in this regard, to note that many of the developing countries that have grown most rapidly have not only adopted outer–oriented trade strategies, but have done so unilaterally and not in the context of a round of trade negotiations under the GATT/WTO.

concession mechanism, at least initially, was highly effective. The more than fifty years after the founding of the GATT witnessed the most rapid rate of expansion of world trade in world economic history. That expansion of trade, in turn, was associated with sustained economic growth at higher rates than the world had ever witnessed. As a rule of thumb, real world Gross Domestic Product (GDP) grew at twice the rate of growth of world trade and was certainly, for most countries, an engine of economic growth.

IV. ECONOMICS VERSUS POLITICS IN THE DOHA ROUND

But in light of the difficulties currently confronting the WTO and the failure to date to reach a conclusion in the Doha Round, it is worthwhile to ask whether the politically-wise concession approach may not have been a contributing factor. Consider first preferential trading arrangements (PTAs), such as the European Union (EU – a customs union) and North American Free Trade Agreement (NAFTA – a free trade area).¹¹ By definition, a PTA is discriminatory. Whereas an MFN tariff discriminates between domestic producers and those in the rest of the world, a PTA tariff discriminates between producers within the countries joining the agreement and the rest of the world. That forming such an agreement may constitute a move toward free trade (if the partners within the PTA are lower cost than producers outside it) and hence represent an improvement in welfare (at least for members) or away from free trade (if trade is diverted from low-cost nonmember countries to members) is well known.¹²

But if the political economy of “reciprocity” is correct, then PTAs are almost surely detrimental to further trade liberalization of the open multilateral

¹¹ A customs union entails a common external tariff with zero tariffs between members. A free trade area (FTA) has zero tariff rates between members, but each member retains its own external tariff (and rules of origin have to be established to avoid transshipment of goods within the FTA from lower tariff countries to higher tariff ones).

¹² For a survey of the literature on the welfare effects of PTAs, see Bhagwati, Krishna and Panagariya (1999).

trading system.¹³ For once a PTA is formed, producers in each of the member states who expand their markets in the other states (behind the common external tariff in the case of customs unions and aided by the zero tariff between them in the case of FTAs) will have either an interest in maintaining the status quo (because they are higher cost than producers outside the arrangement) or less incentive to lobby for increased multilateral opening if they have already secured their market.¹⁴

Moreover, PTAs offer more scope for pressure from industry lobbyists than do multilateral negotiations, in large part because rules of origin (ROOs) can be very obscure and hide high levels of protection (Krueger, 2001). It is thought, for example, that USA automobile manufacturers lobbied for ROOs in the NAFTA so that Japanese firms producing in Mexico would be disadvantaged because of the restrictions on the use of Japanese-made (imported) parts. Likewise in NAFTA, a “triple transformation” rule, whereby a PTA giving zero-tariff treatment to imports of apparel, meant that only when the raw material, the textile, and the fabrication into apparel were all undertaken within the NAFTA, would origin then be conferred. The equivalent levels of protection against imports from third countries for these ROOs have not been calculated, but are evidently significant and surely increased protection above and beyond that the external tariffs provided pre-NAFTA.¹⁵

¹³ Article XXIV of the GATT permits preferential trading arrangements, both customs unions and free trade areas, provided that: 1) trade barriers are lowered to zero; 2) the agreement covers “substantially all” trade; and 3) that the signatories are to reach zero tariffs on a specified time table. See Dam (1970:274ff) for a discussion of the “fiasco” and imprecise nature (from a legal standpoint) of the Article XXIV provisions.

¹⁴ There are arguments that go in the other direction. For example, if those fearing multilateral trade opening learn from experience with a PTA that open trade is beneficial, it might change the political balance. And PTAs include provisions for opening services and liberalizing capital accounts that may result in additional political pressures for further opening of trade.

¹⁵ Customs unions resort to rules of origin less than free trade areas because of the common external tariff in a custom union, but the problem is not absent. In the case of the EU, for example, Japanese firms outsourced the final processing of some products to Europe after an anti-dumping tariff had been imposed, so that a very high fraction of the value added originated in Japan. See Hoekman and Kosteci (2001:166) for a description.

A second area where WTO arrangements fly in the face of good trade policy is the free ride given developing countries in negotiating rounds and preferential treatment of those countries. At least among industrial countries, tariffs are supposed to be lowered with reciprocity. For developing countries, Multilateral Trade Negotiations (MTNs) were negotiated among the industrial countries, and it was assumed that developing countries would benefit by being given a free ride – that is, they had to make no “concessions” in return. From the beginning, developing countries insisted upon, and increasingly received, “special and differential” (S&D) treatment under the GATT.

Two provisions in the GATT were important for policy toward developing countries. On one hand, protection of “infant industries” was to be permitted. On the other hand, all countries were entitled to resort to quantitative restrictions if needed “for balance of payments reasons.”¹⁶ In practice, developing countries used the balance of payments provision of the GATT articles, rather than the infant industry provision.¹⁷

To do this, they had to notify GATT/WTO annually that they had balance of payments difficulties and were maintaining quantitative restrictions for that reason.¹⁸

While economists recognize that there may be infant industries, experience has shown that it is difficult, if not impossible, to identify them in advance, and the very fact of protection may provide the wrong incentives for the development of a new industry. Bhagwati has suggested that infant industries became senescent industries without

¹⁶ GATT Articles XII, XIII, XIV, XV and XVIII, part b all relate to balance of payments exceptions. These exceptions could be invoked when a country wished to forestall or stop a serious decline in reserves or to replenish seriously depleted reserves. The IMF was to be the arbiter on the need for invoking the clause. See Matsushita et al., (2006:460–466) for a discussion.

¹⁷ The infant industry provision was in Article XVIII and permitted protection (both tariffs and quantitative restrictions) by low income countries to foster new industries.

¹⁸ India notified the GATT every year through 2001 that it needed quantitative restrictions for balance of payments reasons.

ever growing up in between! And, at any event, the infant industry exception was seldom used.¹⁹

And, whereas the infant industry argument might justify some form of assistance to new industries, economic efficiency is generally inconsistent with quantitative restrictions on imports for balance of payments reasons. Economic efficiency calls for the allocation of resources between exportables and import-competing goods in such a way that the marginal cost of earning a unit of foreign exchange equals the marginal cost of saving a unit of foreign exchange. In the face of balance of payments difficulties, therefore, the appropriate first-best policy advice is for a change in the exchange rate so that incentives for production both of exportables and of import-competing goods increase.

Save for the infant-industry and balance of payments provisions, however, nothing in the GATT articles provided for the “free ride” developing countries received in earlier GATT rounds. However, by the late 1950s, additional provisions were made so that developing countries could receive S&D treatment within the GATT. Thereafter, they received “preferences” in the form of lower (usually) zero tariffs on their exports to industrial countries than importers paid on goods from industrial countries.

Developing countries were beneficiaries of the rapid growth in world trade (and the reduction in tariff barriers in industrial countries that was one of the principal reasons for it); measures that accelerated the growth of trade, such as a greater reduction in trade barriers because of an MTN round, were highly beneficial to developing countries. Developing countries that opened up their economies and relied more on growth of exports as a development strategy benefited from the greater ease of entry into new markets that resulted from more rapid growth of the

¹⁹ See Baldwin (1969) for an excellent analysis of the difficulties with the infant industry argument.

world economy and lower tariff barriers, but they usually lowered their tariffs and other trade barriers unilaterally.

Countries that maintained inner-oriented trade strategies nonetheless benefited from the rapidly growing international economy and from lower trade barriers. But the developing countries with inner-oriented trade strategies would have been even more successful in achieving their domestic goals of more rapid growth and rising living standards had they lowered their own trade barriers. That this was, and is, so is evident by the success of those countries that did unilaterally liberalized their trade regimes and reduced trade barriers. Ironically, had they participated in MTNs, they might have reduced their trade barriers earlier to their own benefit, and confronted even lower import barriers in developed countries. The “concession” language of the GATT/WTO was certainly misleading, and “giving” the developing countries the right to maintain their trade barriers was no favor. Until the Doha Round, developing countries (including most emerging markets) did not participate very actively in the negotiations, but benefited from the tariff reductions negotiated primarily among industrial countries. Those countries moving to outer-oriented trade strategies, such as Korea, Singapore, and Chile, reduced their trade barriers and tariffs unilaterally.

The developing countries as a group not only believed that they benefited from leaving their high trade barriers intact, but also used their influence to receive the preferences, noted above, rather than reduced global tariffs. However, each industrial country, or group of countries, specified the goods eligible for preferential treatment and the conditions of that treatment. The USA, for example, imposed a ceiling on the amount of any given good that could be imported to the USA from a preference-receiving country duty-free.

The benefits of preferences were greatly exaggerated. Additional exports under preferences originated largely in the highest per capita income countries eligible for preferential treatment. The incentives for producers in preference-receiving countries were not entirely straightforward: on

one hand, if exports of a product became too large, preferential access to the market in question might end; on the other hand, there was uncertainty as to how long preferences would last and whether the exporter in the preference-receiving country would be able to compete once preferences were eliminated. Baldwin (1977) estimated that had developing countries successfully negotiated for a 1 percentage point greater reduction in industrial countries' tariffs on textiles and apparel in the Tokyo round (instead of preferences), the value to the preference-eligible countries would have been greater than the value of preferences they actually received. Most analysts have concluded that developing countries have placed far too much weight on attempting to preserve or increase preferences relative to their value, and far too little on MFN tariff reductions in those rounds.

To compound matters still further, some negotiators from preference-receiving developing countries have expressed concern about multilateral tariff reductions in the Doha Round, noting that any reduction in external tariffs would reduce the value of preferences. Even the French President used the erosion of the value of preferences as an argument against successful conclusion of the Doha Round!

It can certainly be argued that the rhetoric of "concessions," the granting of S&D treatment to developing countries, and the tariff preferences they received all delayed the time at which developing countries would lower their tariff and nontariff barriers and open their economies to trade, to their detriment and that of the world economy as a whole.²⁰

Questions can also be raised about sectoral trade agreements. The first such major agreement was reached in the late 1990s, when forty countries signed the Information Technology Agreement (ITA) under which they agreed to keep current and future IT products duty-free. The agreement covered only the signatories, but other countries were

²⁰ It is estimated that lowering of developing countries' tariffs would benefit other developing countries significantly and result in considerable expansion in south-south trade.

welcome to sign in the future. Signatories were predominantly industrial countries, most of whom had export interests in IT products,²¹ and the intent was clearly to prevent the imposition of protection as new IT products were developed.

However, to the extent that the exporters had already achieved duty-free entry into their major markets through the ITA, any pressure for achieving a satisfactory outcome to the Doha Round that might have come from the IT industry was lost: they already had achieved what they wanted! While the economics of the ITA were good, the consequences for the politics of future rounds were questionable.

Turning lastly to agriculture, the politics of “concessions” may well have been a contributing factor to the inability of negotiators to bring the Doha Round to a satisfactory conclusion to date. Developing countries took the position that the major gains to them would originate in the dismantling of agricultural supports in industrial countries.²² In fact, the major beneficiaries of the reduction in agricultural supports would be in the countries extending them: costs of price supports are high, and benefits go mostly to the larger farmers. The cost of providing income supports for small farmers would clearly be much lower. And, while negotiators had made progress in agreeing to end export subsidies, an important step, efforts to negotiate reduced overall support (in the industrial countries) in return for reduced protection and a relatively high threshold before safeguards could be imposed because of “import

²¹ That there are difficulties with the commitment to keeping future new products duty-free can be seen in the current dispute between the USA and Europe as the USA is claiming that the EU is imposing duties on new IT products. The EU asserts that the agreement should be renegotiated. See *Financial Times*, 9/18/08, p. 6, “Europe Wants IT Trade Pact Back on the Table”.

²² It is worth noting that it was not until the concepts of aggregate measure of support and producer subsidy equivalent were developed (by technocrats) that there were meaningful negotiations centering on agriculture. Even then, agricultural negotiations take place separately from negotiations over other commodities (until the final stage) which makes cross-sector trade-offs difficult.

surges” (in emerging markets and developing countries) failed.²³ Yet the biggest beneficiaries of the (beginning of) rationalization of agricultural production and trade would have been the countries that undertook rationalization.²⁴ The politics of “concessions” and farm price supports for “small farmers” who by definition produce smaller quantities and therefore benefit less than large farmers carried the day, despite the economics.

V. THE FUTURE OF THE MULTILATERAL TRADING SYSTEM

Given the problems in the Doha Round, a major question is the future of the open multilateral trading system. On one hand, the very success of the GATT/WTO in providing a framework for tariff reductions and rules on other treatment of imports has left the remaining tasks more challenging. So, too, has the increased membership. On the other hand, the gains from the system have been so great that it is difficult to imagine that the system would break down.

A multilateral trading system has so many advantages that no substitute, based on bilateral or regional trading arrangements, seems possible. Equally, restarting from a zero base and devising an entirely new international economic organization seems infeasible, or worse yet, destined to reduce rather than increase global economic integration.

²³ The reported Indian position is perhaps indicative of the gap between rhetoric and economics. It was reported that the Indian negotiators refused to accept the lower “import surge” limit of 15 percent because of concerns about the incomes of “small farmers.” But Indian prices of major grains are delinked from, and below, world prices and India is a net exporter of food grains. Imports have occurred only in years when harvests were poor and prices domestically were high. It is thus difficult to understand how small farmers would have benefited from the larger limit.

²⁴ It is also noteworthy that simultaneous rationalization (with, for example, reduction of farm supports in Japan, the USA, and Europe) with opening up of markets in developing countries would have made the needed adjustments less in each country than would be required if one country unilaterally removed its interventions.

The way forward would therefore appear to be piecemeal changes that can improve the functioning of the system.²⁵ In the remainder of this paper, I consider some of these possible changes. They could either be undertaken individually, or they could be adopted as a package. If undertaken individually (or with a small number of changes at a time), there need not be any particular order. And none of the changes suggested here would, by themselves, constitute a major overhaul of the WTO, but cumulatively, the adoption of most, if not all of them, could improve the functioning of the system.

It is assumed that the Doha Round will be concluded within approximately two years. The discussion below does not focus on “how to conclude” Doha Round, although the measures suggested here could be undertaken concurrently with the conclusion of the round, or afterward.

There are a number of items, but they can be broadly grouped into three categories: changes in the WTO structure and decision-making processes, changes in WTO rules governing aspects of trade, and mechanisms for covering some of the “new issues”.

VI. STRUCTURE AND DECISION-MAKING PROCESSES

Turning first to the WTO structure and decision-making processes, a number of concerns have been raised. Unanimity between more than 150 members is an incredibly high hurdle for achieving conclusions to negotiations. The Secretariat is small, underfunded, and weaker than it might be. Representation of each country in the monthly meetings of the General Council, without a relatively strong smaller group, raises questions. Enforcement sanctions or incentives could be strengthened.

²⁵ This is not to argue that there should not be another round of multilateral trade negotiations, but the possibilities discussed in this section could be undertaken independently of, and between, rounds.

Several suggestions have been made with regard to the need for unanimous agreement prior to conclusion of a Round. One possibility would be to require some sort of supermajority, with trade liberalization agreed and undertaken by the supermajority not extended to those not approving. Thus, if a significant supermajority of countries approved the proposed final agreement, but there were a few holdouts, the agreement could nonetheless proceed.

The advantage of such an arrangement is obvious: it would remove the possibility of one or a few countries vetoing the entire round. The disadvantage is also clear: it would require a very high threshold of countries trading in the product and reduce the incentive for other countries to follow suit. The ITA was an agreement signed under the WTO in which not all countries participated. But the agreement was reached only after countries representing 90 percent of trade in IT products had signed on. And countries not signatory to the agreement were “free riders” while products not of interest to the major actors were left out of the agreement. One negative effect was that producers of IT goods covered under the agreement were inactive in supporting the Doha Round (Hoekman and Kostecky, 2001:231ff). To make such a mechanism effective, some sort of inducement to the hold-outs to accept the agreement would be needed. One possibility would be to not require members of the supermajority to liberalize their trade with nonsignatories to the agreement. The obvious drawback is that it would require discrimination, going against the MFN principle, and would require relatively complex customs administration, probably inducing transshipment of goods through signatory countries.

But while achieving a supermajority agreement in a Round might prove difficult, a second and related major issue is representation at the WTO. Just as the IMF and the World Bank have been accused of underrepresenting some of their membership in their voting (where voting rights per country are based on a weighted formula including the size of a country’s trade as well as of its GDP), the WTO can be accused

of underrepresenting the very large trading nations with the one-country, one-vote (or requirement of unanimity) principle. This was relatively less important when the “quad” countries were first among equals in a small group of countries but as membership has increased, the awkwardness of decision making has increased.

Moving to a voting formula for decisions such as accession of new membership, round agendas, and the like, which more accurately reflected the country’s stake in the trading system would make sense. One possibility would be to weight countries’ votes by some combination of their weight in international trade in goods and services and their population.

A related structural issue is the absence of an effective intermediate body between the full membership and the secretariat. If countries’ votes were weighted (or even if they were not) it would be possible to have an Executive Council (similar to the World Bank and IMF) where the largest trading countries (presumably the USA, Europe, Japan, and China) held individual seats but where other representation had to be through a Council member representing a minimum number of votes. Countries would be free to choose their own partners in determining chairs. Other arrangements are possible but over the longer term, the functioning of the WTO would be greatly improved if such a body, regarded as legitimate, could function. Issues such as agenda preparation could be addressed, and then sent to the entire Council, or to a Ministerial or member governments for final approval.

Another issue relates to the size and funding of the Secretariat. The WTO staff produces a very large volume of high quality work – Trade Policy Reviews (TPR), annual reports, trade data, and preparatory work for all meetings – but is very thinly stretched. Additional resources could be well used for the (very small) research staff, for support of trade facilitation and the TPR process, and improving information flows.

These, and other, ways to streamline and strengthen the functioning of the WTO could be done incrementally or as a package. The results of any individual reform would be positive, but the cumulative effect could be substantial.

A related, but separate, issue concerns dispute settlement procedures (DSP). Despite the improvements already made, dispute settlement procedures are still long and arduous, and large trading nations are at a great advantage relative to smaller ones in resorting to the DSP. It is clearly desirable to have procedures that give the differing parties incentives to resolve their disputes.

VII. CHANGES IN RULES GOVERNING TRADE

One of the serious challenges to the open multilateral trading system arises from the proliferation of PTAs, as discussed above. Each one has different provisions for rules of origin (200 pages, single spaced, in the NAFTA agreement), different timetables for tariff reduction, and different provisions for non-goods trade (such as agreements on treatment of foreign direct investment-FDI).

The discrimination inherent in these agreements flies seriously against the MFN principles, and, for reasons discussed above, can reduce support for further multilateral liberalization. One way to attempt to mitigate the discriminatory potential of PTAs would be to agree on a tighter set of rules governing them. One possibility would be to require PTAs to make all ROOs within a given agreement based on percentage of value added. One could go even further and require that the value added percentage should be the same across all goods. This would reduce, and perhaps even eliminate, some of the most egregious protectionist measures that can be embodied through ROOs in PTAs. Questions would arise, of course, as to the fate of already-negotiated PTAs. They could, of course, be grandfathered and left unaffected, or there could be a

transition period during which existing PTA ROOs could be converted to a value added percentage.

Making the ROOs in all new PTAs a specified percentage of value added would also greatly increase their transparency. And if the percentage of value added specified were the same for all new PTAs entered into by all countries, negotiators could be assured that their PTA would not be “bested” by a lower percentage value added requirement in another one negotiated by their trading partners.

An alternative would be to have clauses in PTAs that specified that, if in future a country negotiated a PTA with a lower value added threshold for preferential treatment, that lower rate would extend to existing PTAs (this would be a sort of MFN among preferential trading partners). An advantage and difficulty with this, of course, is that it would increase opposition from industries benefiting from the protection of a higher value added requirement.

Yet another possibility, not inconsistent with the uniform ROO requirement, would be to adopt a rule that would require PTA signatories to admit any other country that would agree to the existing PTA rules. For example, if this rule had been in effect when NAFTA was negotiated, the Japanese could have signaled their willingness to abide by the rules and joined. Discrimination against their auto parts in Mexico would thereby have been thwarted.

These, and other, possibilities for achieving greater potential consistency of PTAs with the WTO’s MFN principle would require careful thought. Issues would include how non-trade related aspects of PTAs would be treated²⁶ as well as the timing for phase-in of the new rules for

²⁶ The non-trade aspects such as treatment of foreign direct investment could be resolved by splitting PTAs into two parts: one would consist of the trade-related issues where uniformity was mandated, while the other could consist of those provisions relating to non-trade measures (such as mutual recognition of phytosanity standards). But there are also some institutional issues that would require resolution, such as how dispute resolution bodies set up under a PTA between countries A and B would be affected when country C chose to join.

agreements already under negotiation, new ones, and possibly even for existing ones.

Other issues could also be addressed. Countries might negotiate a threshold below which tariff lines would go to zero – this could be two percent, three percent, or a larger percentage, but it could simplify customs administration. There could also be a higher *de minimis* standard for Antidumping (AD) – Countervailing Duty (CVD) filings, acceleration of the dispute resolution process (including possibly alternative procedures such as mediation or arbitration) to speed up resolution, and greater standardization of AD and CVD procedures across countries. Greater reliance on mutual recognition of standards is normally undertaken bilaterally. “Trade facilitation” – providing technical assistance to low-income countries in exchange for conforming with WTO agreements on procedures and mechanisms – could be strengthened.²⁷

VIII. MECHANISMS COVERING NEW ISSUES

It has already been argued that agreements covering single sectors are problematic: those exporters benefiting may fail to support further multilateral negotiations. Furthermore, the ability to negotiate cross-sectorally will in general widen the range of possible mutually beneficial agreements.

But there are areas that are largely untouched where agreements on how to negotiate are probably a prerequisite for significant progress. Services is an area in which the potential gains from liberalization are very large, yet where the lack of a mechanism for quantification or comparability across sectors is a major obstacle to progress.²⁸ There are undoubtedly

²⁷ This is an issue which could be negotiated jointly in a case where developing countries might otherwise be reluctant to agree (such as removal of tariffs below a certain threshold).

²⁸ An imperfect indication of the scope for gains is that services are estimated to comprise 25–30 percent of world trade in goods and services (and are growing rapidly) while they account for over two thirds of GDP in most countries. See Mattoo and Stern (2008) for an overview of

huge gains to be had: financial and other business services are a major source of high productivity in most industrial countries. Access to these services by low-income countries would carry large benefits. But other services, such as construction, could provide large employment and income opportunities for workers from low-income countries while enabling lower cost residential and commercial real estate services in industrial countries.²⁹ Perhaps the most important is in the case of services, where there appear to be large potential gains from liberalization of trade, and at the same time, major problems arise in negotiations.

At present, there is no agreed-upon plausible way in which to value the “concessions” that industrial countries might make by permitting construction workers to have temporary work-and-residence; likewise, valuing the liberalization of financial, or of other, business services, has not been undertaken in a generally accepted way. Estimation of the height of protection received by domestic construction firms (by refusal to permit entry to foreign workers), or the value of reduction in protection to permit entry to a specified number of workers, has not yet been undertaken in a widely accepted manner. Yet if services liberalization is to be undertaken on a significant scale, a technique is needed for assessing these, and other, potential liberalizations. Only then could multilateral negotiation take place in the expectation that concessions would be “reciprocal”.

That there are potentially major gains from the opening of business and financial services, construction, professional and personal services, and international transport is widely recognized. But the difficulties are large. The formation of the General Agreement on Trade in Services (GATS) in

services trade. See Maurer, Marcus, Magdeleine and d’Andrea (2008) for a discussion of the problems associated with gathering data on the value of services.

²⁹ Enabling construction workers from low-income countries to reside in high-income countries while engaged in construction activity would not necessarily entail migration: it would be possible for firms undertaking the construction to receive temporary work-residence permits while construction was in progress.

1995 was a first step, and efforts to improve the measurement of services transactions are underway. But even when estimates of the volume and value of services trade are available, a metric for estimating the level of service trade restrictions will be needed. Just as the producer subsidy equivalent (PSE) and aggregate measure of support (AMS) framework enabled an advance in agricultural negotiations, a conceptual framework for estimating the barriers to trade in services would greatly increase the likelihood of fruitful negotiations across service sectors.

Some services (maritime shipping, construction, back office processing) seem to be ones in which developing countries may have a comparative advantage, while others (air transport, most professional services) seem to lie more in the range of activities where industrial countries are at lower cost. Major liberalization of services is therefore not likely unless cross-services negotiations can take place. And that is unlikely to happen until there is a framework for estimating the tariff equivalent of barriers.

Beyond services, there are other areas where major gains would result if multilateral agreement on liberalization could be achieved. One such area is the treatment of foreign investment. To date, a comprehensive investment agreement has escaped the international community, and bilateral agreements and treatment within PTAs are the main mechanisms for facilitating investment.³⁰ To reach a multilateral agreement within the WTO will require a great deal of effort and negotiations. It would most likely prove to be worthwhile to try to break apart the various components of such an agreement and dispute resolution.

A major issue which has been raised for several decades but upon which little has been achieved is competition policy. Clearly, large firms trading

³⁰ It will be recalled that, in the 1990s, an effort was made to hammer out a multilateral investment agreement under the auspices of the Organization for Economic Co-operation and Development (OECD). That effort failed, in significant part because the recipients of FDI in developing countries were not part of the negotiating forum.

across borders could benefit substantially from the certainty that would arise if competition policy were uniform across countries. Given the very different economic structures of WTO members, however, it is unlikely that this is an issue upon which much progress can be made in the near future.

Perhaps the most difficult of the new issues, however, is that concerning trade and the environment. Environmental concerns are themselves a major focus of international attention, and there are numerous proposals to link environmental policies to trade. The issues are too complex to be addressed here. Unlike issues such as competition, however, it is very likely that policies with such links will be adopted within the WTO context, by a new international arrangement, or through various bilateral agreements. A challenge for the multilateral trading system will be to insure that these measures are least-cost and do not introduce hidden protection into the system.

IX. CONCLUSIONS

A flawed rationale for trade liberalization (“concessions”) was good politics and led to a good economic outcome. It is almost inconceivable that the 150-plus members of the WTO would agree to a new set of rules with a rationale more closely approximating good economics, and even if it could happen, it is questionable whether trade liberalization could proceed as rapidly as it has under the “concession” framework.

However, even if the Doha Round concludes, there will be a variety of important issues where the “reciprocity”-“concession” framework is unlikely to provide the impetus to good economic outcomes. These issues can perhaps best be dealt with in stand-alone negotiations apart from MTNs. Changing the decision-making processes within the WTO could be tackled on a stand-alone basis. Bringing developing countries more closely into the WTO discipline and taking them away from the S&D and preferential framework would serve those countries and the world

well, but is politically difficult. Finding rules that will render PTAs more consistent with an open, nondiscriminatory multilateral trading system may be possible, but it is not likely that the political logic of concessions and reciprocity in liberalization will be helpful. And agreement on improved rules for AD and CVD, investment, and new aspects of trade policy is unlikely to be achieved through the reciprocity/concession framework. Those arenas can therefore constitute a work agenda to be carried out outside the context of a new round of trade negotiations.³¹

For services trade, the biggest challenge is different: it is technocratic, and involves devising measurement tools for estimating the height of existing barriers. If that challenge can be met, it is possible that the reciprocity/concession framework could then again provide the basis for a new round of trade negotiations. First, however, the Doha Round must be concluded. With that done, and some of the stand-alone agreements in place, a new round could be contemplated where once again the politics of the reciprocity framework can result in good economic outcomes. In the meantime, however, completion of the Doha round, and addressing some of the issues discussed above, can yield sizeable dividends to the international economy and preserve the open multilateral trading system which has served it so well.

³¹ It is even conceivable that – even assuming that progress is made in completing the Doha Round – further progress in agricultural trade liberalization could take place without a full round of negotiations. After all, there has been little cross-sectoral trading between Non-Agriculture Market Access (NAMA) and agricultural issues to date.

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