
CHAPTER 1
**THE CASE FOR A MULTILATERAL TRADE
ORGANIZATION**

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1.1 INTRODUCTION

THE General Agreement on Tariffs and Trade (GATT) and its successor, the World Trade Organization (WTO), are generally regarded as the most successful international economic organizations established in the post-First World War period.¹ Most agree that the two other most prominent international institutions established in the period, namely the International Monetary Fund and the World Bank, have both fallen short of fulfilling the roles for which they were created. The most important accomplishment of the GATT/WTO has been a significant reduction in the levels of tariffs and non-tariff trade barriers that had emerged during the great depression of the 1930s. Average tariff levels on manufactured goods in most industrial countries have fallen from 40–50 per cent in 1948 to about 3–5 per cent today through a series of eight multilateral negotiating rounds.

A second major accomplishment of the GATT/WTO has been the establishment of a reasonably successful self-enforcing system of settling disputes among members in which panels of trade experts and, more recently, an appellate body, render judgments concerning the consistency of particular trade measures with GATT/WTO principles. Adherence by members to the two basic principles of GATT/WTO, namely that in the absence of a free-trade agreement or customs union the most favourable tariff treatment extended to one country must be extended to all countries (the most-favoured

nation principle), and that foreigners must receive the same treatment as domestic citizens (the national treatment clause), has also proved to be very successful in reducing tensions among trading countries.

Thus, one approach to making the case for a multilateral trade organization is to provide a historical description of the various trade negotiating efforts of GATT/WTO members that have led to the significant liberalization achieved. Another approach is theoretical, namely to investigate the trade policy actions that welfare-maximizing governments, who preside over large countries, will take, as well as their effects on world welfare. The following two sections present the theoretical cases for trade agreements, while Sections 1.4–1.6 review the main trade-liberalizing and dispute resolution accomplishments achieved under the GATT/WTO framework. Section 1.7 briefly summarizes the main points of the chapter.

1.2 TERMS OF TRADE EXTERNALITIES

As Bagwell and Staiger² have pointed out, a problem that arises when large countries set tariff rates so as to maximize national welfare is that they become involved in pursuing ‘beggar-my-neighbour’ trade policies. This occurs because the imposition of a tariff by a large country gives rise to an externality that reduces the national welfare of other countries and increases economic welfare in the tariff-setting country. This is because the prices received by foreign exporters fall as a consequence of tariffs being imposed on their exports, i.e. the terms of trade of foreign exporters decline, and the terms of trade of the tariff-imposing country improve.

Consequently, in unilaterally setting its tariffs, a large country engages in beggar-my-neighbour activities by imposing import duties on imports whose supply prices can be influenced in this manner. However, other large countries will also engage in beggar-my-neighbour policies in the process of maximizing their national welfare, and will impose tariffs on their imports of products from the initial tariff-raising country. By lowering the supply prices of these imports, this retaliation process offsets the terms of trade improvement for the initial beggar-my-neighbour country so that on balance no one tends to gain. It is usually assumed that a Nash equilibrium position is eventually reached when further increases in tariffs no longer reduce the economic welfare of other countries. However, the distortions brought about by the retaliatory tariff-raising process result in the economic welfare of all the participants being reduced below their free trade levels.

The essential point can be seen from a simple supply and demand diagram.³ In Figure 1 let the curve D_M be the net import demand curve of a large country (country 1) for a particular product (shoes, for example) and S_X be the net export supply curve of other countries for this product. In the absence of any tariff, the equilibrium price paid by the importing country (and received by the exporting countries) for the product will be Op , and the volume of trade will be Oa .⁴ Now assume that importing country (country 1) imposes a specific duty equal to $p'p''$ on its imports of the product. The import supply curve will shift upward by this amount to $S_X + T$, with the price paid by the importing country rising to Op' and the volume of trade declining to Oh . The price paid by the importing country does not increase by the full amount of the duty but only by

pp' , since the cost of producing the export good falls from Op to Op'' as demand is reduced from Oa to Oh . The tariff revenue collected by the importing country equals the area $p'cep''$. Thus, part of the burden of the tariff falls on the exporters of the good, namely the area $pdep''$. The other part of the tariff, an amount equal to the area $pp'cd$, is borne by consumers in the importing country who pay a higher price for the traded good. The government of the importing country gains revenue equal to the area $p'cep''$, which exceeds this amount by $pdep''$. This sum, which is assumed to be distributed to the consumers of the taxed product through a costless lump-sum redistribution process, represents a gain in national welfare for the tariff-imposing country.⁵

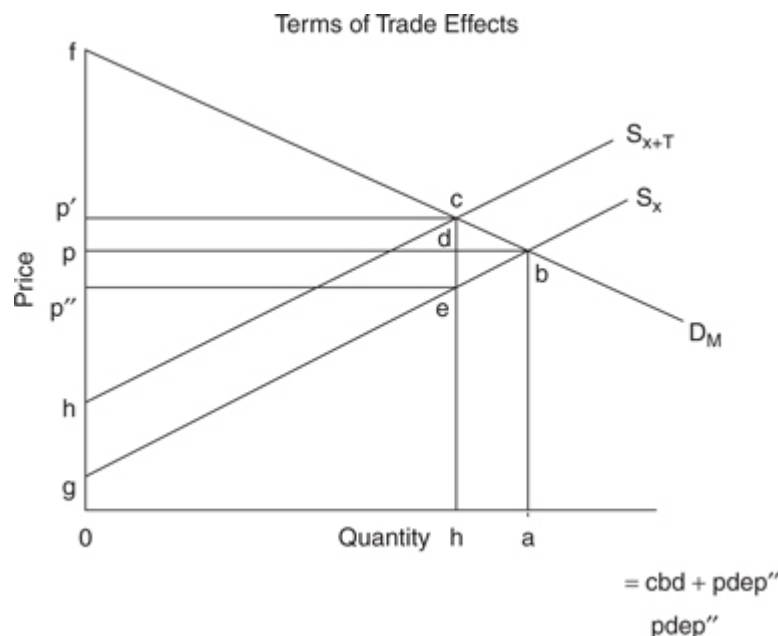


FIGURE 1 Terms of trade effects

The sequence of events will not end here, however. Other large countries will take retaliatory action in an effort to increase their national welfare. Since the imports of these countries include the

exports of the initial tariff-imposing country, this latter country faces decreases in the prices of its exports, which offset the improvement in its terms of trade when it alone imposes import duties. The end result of this beggar-my-neighbour process will be welfare levels for all the participating countries that are lower than their initial free trade levels.

A trade agreement provides the means by which welfare levels can be restored to their free trade levels. If countries engage in negotiations with each other to reduce their tariffs on a reciprocal basis, both further adverse terms of trade effects will be avoided for any particular country, and trade and welfare levels will move back toward their free trade levels.

1.3 THE POLITICAL ECONOMY AND COMMITMENT APPROACHES TO TRADE AGREEMENTS

Although there is no dispute over the logic of the terms of trade argument, there is disagreement over its practical relevance for trade agreements. In tariff-setting discussions among policymakers, one does not typically observe any reference to the terms of trade. Instead, in providing protection to particular sectors, policy makers cite such justifications as equity considerations, e.g. protecting employment and income levels of unskilled labour, offsetting unfair practices on the part of foreign countries, such as dumping, and responding to the pressures of politically powerful industries such as the textile sector. In other words, governments pursue political objectives in their tariff-setting actions.

Bagwell and Staiger recognize the importance of political economy considerations in the real world tariff-setting process. The only structure they place on government preferences is the weak

condition that, with domestic prices held constant, welfare increases with an improvement in the terms of trade. They then proceed to show that with such preferences a political economy approach to trade agreements does not offer any separate political purpose for a trade agreement.

Another argument for trade agreements stresses the difficulty that governments have in making policy commitments to the private sector, and suggests that trade agreements may provide a way to enhance policy credibility. Suppose that a government sets its trade policy after producers make their production decisions. As Bagwell and Staiger explain:

In this case, the governments may have an incentive to surprise producers with a level of protection that it would not choose *ex ante*, when producers' selections are still unsettled. The government's preferred *ex ante* and *ex post* tariff decisions differ, since, once producer decisions are determined, the government recognizes that its choices only affect consumption decisions. Of course, if producers understand the government's incentives, they will alter their production decisions in anticipation of the government's actions, and production decisions are therefore distorted. This production distortion is the real cost of trade-policy flexibility, and the identification of this cost suggests that a trade agreement would increase (*ex ante*) government welfare if it enables the government to commit to its (*ex post*) preferred tariff.⁶

Unlike the theoretical world we often postulate, the real world in which economic agents operate is characterized by such conditions as the lack of perfect knowledge and the lack of perfect mobility among productive factors. As a result of these conditions, underlying market opportunities among countries go unexploited that could increase collective economic welfare across countries. However, the formation among countries of international institutions such as the GATT and the WTO can serve to offset the consequences of these market imperfections. For example, with the establishment of government offices to collect and process relevant data needed to conduct trade-liberalizing negotiations, mutually beneficial trading opportunities can be revealed and exploited. These include not only income-increasing opportunities arising from current market imperfections, but welfare-increasing opportunities associated with protectionist measures taken in previous periods. Thus, as the preamble to the General Agreement of Tariffs and Trade states, ‘relations within the field of trade and development should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the productions and exchange of goods’.

1.5 NEGOTIATING TECHNIQUES AND RESULTS

In the early days of the GATT, members first exchanged lists indicating the goods on which they were willing to offer tariff reductions and the goods on which they were seeking reductions from other countries. They then negotiated bilaterally with the principal suppliers of the goods on which they sought tariff

reductions. The goal was to achieve a balance of concessions made and received.

While this procedure worked reasonably well in the early rounds of GATT negotiations, it was hampered by the fact that the volume of imports for which one country was the principal supplier to another country could differ widely from the volume of imports for which the second country was the principal supplier to the first. This limited the depth of the average tariff cut at which it was possible to achieve a balance of concessions received and granted to others. For example, while the average cut in all duties achieved in the first GATT round of negotiations in 1947 was 32 per cent, subsequent trade-liberalizing rounds utilizing the same principal-supplier approach reduced average duties by only 1.9 per cent in a second round in 1949, by 3.0 per cent in a third round in 1950–51, by 3.5 per cent in a fourth round in 1955–56, and 2.4 per cent in a fifth round held in 1961–62.

Thus, in the following round of negotiations, the so-called Kennedy Round (1964–67), the United States proposed that, as a means of achieving a meaningful average tariff reduction, the major trading countries reduce their industrial tariffs by 50 per cent across the board, with a minimum number of exceptions. This proposal was essentially accepted by other GATT members and, as a result, average duties were reduced in the trade negotiations by 36 per cent.

While this result left average tariffs on industrial goods roughly the same among the major participants in the negotiations—the United States, the European Community and Japan—the dispersion of the rates around the means differed widely. This was because the

Common External Tariff of the EC was formed by averaging member country rates, a procedure that resulted in a concentration of rates in the 10 to 15 per cent range. The United States had over 900 tariff line items over 30 per cent, whereas there were only a handful of such rates in the EC's tariff schedule. Community members argued that this was unfair because an equal cut in high US and middle level EC rates would increase US exports to the Community much more than EC exports to the United States. It was simultaneously argued that cuts in the larger number of low-duty US rates were not worth much in terms of increased exports for the EC, because these low duties were already only a minor obstacle to trade. Furthermore, an equal cut would increase imports into the EC from third countries more than such imports into the United States. In other words, exports from third countries would be diverted (in relative terms) from the United States to the EC.

While the US did not buy these arguments, it agreed in the following round of negotiations, the Tokyo Round (1973–9), to a tariff-reducing formula that cut high duties by a greater percentage than low duties after it found from test runs on a representative sample of US and EC imports that the EC proposal actually resulted in a smaller balance-of-payments deficit.

The tariff-cutting formula for industrial products accepted by all participants in the Tokyo Round negotiations was proposed by the Swiss, namely:

$$Z = AX/(A + X)$$

where Z is the new tariff rate, A is a constant and X is the current tariff rate. The constant was set at 14 for the US and 16 for the EU.

Thus, a US duty of 20 per cent was reduced to $14 \times 20 / (14 + 20) = 8.23$ per cent. The United States was somewhat constrained by this formula, in that it could not cut duties more than 60 per cent, but it was able to raise its average rate of reduction to the levels achieved by other industrial countries by utilizing its statutory power to reduce duties of 5 per cent and below by up to 100 per cent. Taking into account the various exceptions to applying the Swiss formula, the average reduction in tariffs on industrial products in the Tokyo Round was about 35 per cent for both the US and EC.⁷

Besides achieving a significant average duty reduction in the Tokyo Round, GATT members also negotiated a series of detailed codes covering non-tariff measures that set forth permissible and non-permissible GATT-consistent behaviour. The main subjects covered were subsidies and countervailing duties, anti-dumping practices, government procurement policies, valuation and licensing practices, and technical barriers to trade (standards). Signing the codes was made voluntary on the part of the participants in the negotiations.

The most successful post-World War II multilateral trade negotiation, as measured by the depth and scope of liberalization, was the Uruguay Round (1986–93). Three new subjects not covered in previous negotiating rounds were introduced: trade in services, trade-related intellectual property rights, and trade-related aspects of investment measures. In addition, a special effort was made that brought agriculture and textiles/apparel under GATT discipline. The negotiations also covered such traditional topics as tariff liberalization, subsidies, dumping, government procurement policy,

technical barriers to trade, dispute settlement, and institutional reform.

An important feature of the framework agreement negotiated for services is that it covers not only cross-border trade in services, but services supplied by foreign firms within a country to consumers in that country and services supplied by domestic firms to nationals of other countries who are visiting the country. The General Agreement on Trade in Services (GATS) commits WTO signatories to a set of general principles which includes most-favoured nation treatment, transparency with regard to domestic laws affecting trade in services, and the progressive liberalization of traded services.

In fashioning policies covering intellectual property, namely creations of the mind such as inventions, literary and artistic works, and symbols, names, images, and designs used in commerce, society must balance two output-creating forces. One is the output gains that comes about from distributing an existing body of knowledge as widely as possible. The other is the output gains that arises because inventors and other creators of intellectual property are granted temporary monopolies that prevent others from copying their intellectual creations before they have had a chance to reap the monetary gains that make their creative efforts worthwhile. The Uruguay Round Agreement on the Trade-Related Aspects of Intellectual Property attempted to overcome some of the drawbacks of the existing system. For example, all countries are now required to provide copyright, trademark, and patent protection on goods and services for a specified number of years. However, developing countries and the least developed countries were given extra time to implement this requirement. In addition, countries are required to

establish civil judicial procedures whereby individuals and firms can seek to enforce their intellectual property rights. Criminal procedures must also be put in place to deal with wilful trademark counterfeiting or copyright piracy on a commercial scale. In a notable ruling in 2009, a WTO dispute-settlement panel ruled that China violated WTO rules by barring copyright protection for movies, music, and books that have not been approved for publication or distribution in China.

1.6 DISPUTE SETTLEMENT PROCEDURES

Equally important to achieving a significant degree of trade liberalization by establishing a multilateral trade organization is the goal of successfully resolving disputes that arise among GATT/WTO members as they apply the basic rules of these institutions. Most of these rules were agreed to by 1947 and set forth in the Articles of the General Agreement on Tariffs and Trade. New rules were added when the World Trade Organization replaced the GATT in 1994 and a new agreement covering trade in services was approved. GATT/WTO rules were also routinely modified in the various rounds of trade negotiations.

The basic rule governing trade is set forth in the first Article of the GATT and the WTO as the most-favoured nation principle. It states that the most favourable treatment with respect to any charges imposed on imports or exports by a country shall be the treatment granted to all other countries. However, there is an exception to this rule if a country enters into a free trade agreement or customs union with another country. Thus, trade is free among members of the European Union or members of the North American Free Trade Agreement, namely the United States, Canada, and

Mexico. Since the early 1990s, free trade agreements have become a very prominent feature of the multilateral trading system. As of July 2010, 574 regional trade agreements have been notified to the GATT/WTO. It is not as yet clear just what the long-run effect of this trend will be on the degree of liberalization achieved under the GATT/WTO system.

Among the other rules of the GATT/WTO are:

- when governments can levy anti-dumping and countervailing duties on foreign exports to offset dumping by foreign firms and subsidization by foreign governments;
- when governments can withdraw tariff concession because an industry is seriously injured;
- the conditions under which governments can grant subsidies to their domestic industries;
- the permissible procedures for valuing imports for the purpose of levying import duties;
- when governments can impose quantitative restrictions on imports; and
- the extent to which purchases from domestic firms are provided with a price preference compared with purchases from foreign firms when it comes to purchases by government agencies.

If a GATT/WTO member believes that benefits to which it is entitled from the GATT/WTO agreements are being nullified by an action on

the part of another member (perhaps because this other member believes the country is not following the rules of the organization), the country may request a formal consultation from the country taking the action. If the dispute is not resolved through consultation, the two disputants may then request that a panel of experts be appointed to investigate the case and render a decision. The members of the panel must be agreed upon by both disputants. If, after their investigation, the panel rules in favour of the party initiating the case, the GATT/WTO can then authorize the winner of the dispute to impose sanctions on the losing party.

Unfortunately, prior to the Uruguay Round Agreement in 1994 this procedure was deeply flawed because decisions by GATT members required unanimity. Thus, the losing party in a panel report could block adoption of the report and even block the winning party's request to retaliate if the losing party did not comply with a panel report that was adopted. The Understanding on Rules and Procedures Governing the Settlement of Disputes reached in the Uruguay Round significantly changed the previous dispute settlement process. Most importantly, the principle of 'automaticity' was introduced into the new Agreement. Now, formation of panels, adoption of their reports, and, if a panel ruling is not complied with, retaliations are all automatic. These changes in themselves greatly strengthen the dispute settlement process.

There are several other ways in which the process has been strengthened. A unified system to settle disputes arising under the various agreements replaces the various different procedures for settling disputes under the Tokyo Round agreements. This system even applies to disputes arising over issues on which there are no

legal obligations under the GATT. Time limits have also been established for carrying out the various steps in the settlement process. For example, panels appointed by the Dispute Settlement Body to render a decision on the merits of a complaint must normally report their findings within six months and in no longer than nine months. Another important change is the creation of an Appellate Body to review panel decisions that are appealed. This body has seven members who are appointed for a four-year term. The decision of this body must be made within 60 and 90 days.

It should be noted that panel rulings are *not* self-executing. If a country chooses not to change its laws or regulations to conform to a panel ruling, the penalty it will incur will be the possibility of retaliatory actions by its trading partners. However, such a country is likely to find it more difficult to persuade other countries of the merits of the cases it brings before the Dispute Settlement Body.

1.7 SUMMARY

The strongest case for a multilateral trade organization can be made simply by chronicling the history of the GATT and WTO in achieving trade liberalization actions since 1948. The increased communications among countries that resulted from establishing the GATT and WTO has revealed a steady stream of mutually beneficial trading opportunities that have been exploited through a series of eight multilateral trade negotiations. This liberalization has covered both tariffs and non-tariff trade barriers and involved a variety of trade-liberalizing techniques. Significant progress has also been made over the period in developing dispute resolution methods that have served to strengthen the multilateral trade system.

There are also theoretical reasons why countries form trade agreements. Consider a situation in which goods are produced under increasing cost conditions and countries are large in the sense that their purchases of goods from other countries affect the international prices of these goods. Under these conditions, welfare-maximizing governments are likely to become involved in beggar-my-neighbour trade policies. This occurs because by imposing tariffs on foreign imports and reducing output in these industries each large country can improve its terms of trade, that is, reduce the prices at which it purchases imports relative to the prices at which it sells its exports. The net result of each country taking actions to improve its terms of trade will be a situation in which world welfare declines below its free trade level. At this stage governments realize that forming a trade agreement and reducing import duties on a reciprocal basis can increase the volume of trade without worsening their terms of trade.

A separate approach to the theory of trade policy can be made if it is posited that the purpose of a trade agreement is to tie the hands of member governments against private agents in the economy, and thereby offer an external commitment device.⁸ There exists the possibility that an anticipated trade-policy-lobbying relationship between the government of a small country and producers in one of its sectors could distort the equilibrium in allocation of resources in the economy toward the sector with the active lobby. The government will be compensated by the lobby for the *ex post* distortions its trade policy choices impose on the economy. But the lobby will not compensate the government for the *ex ante* distortions in the sectoral allocation of resources created by the

anticipation of the government's relationship with the lobby, and this provides an opening for the government to wish to tie its hands *ex ante* against the possibility of being influenced by *ex-post* lobbying. A possible commitment role for a trade agreement is thereby identified.

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