

CHAPTER 2

The WTO and the World Trade System

Economic production has gone global during the last 20 years. Not so long ago, world trade involved almost exclusively the exchange of finished goods. Toyota, for instance, produced cars in its Japanese factories and exported these vehicles to, say, the United States. Today, intermediate goods—goods that are assembled together into finished goods—make up a growing proportion of trade. Toyota now sources the components for its autos from producers throughout the world and these components are shipped to factories in the United States (and 15 other countries) where workers assemble them into cars and trucks sold to American consumers as well as exported to more than 20 countries around the world. Global production networks such as these (often called “global value chains”) are increasingly common in today’s global economy. Consider Nutella, a cocoa-hazelnut spread produced by the Italian Ferrero Group. Ferrero sources the cocoa they use for Nutella in Nigeria and it draws its hazelnuts from Turkey. It sources its sugar from Brazil, while the Vanillin comes from China and the Palm Oil comes from Malaysia. Ferrero transforms these various ingredients into its tasty spread in nine factories located throughout North and South America, Europe, and Australia. The entire production network is managed from corporate headquarters in Alba, Italy.

The fragmentation of production into these global networks (a development we look at more closely in [Chapter 8](#)) has been made possible by the dramatic liberalization of and associated rapid growth of world trade flows. Global trade has grown during the last 70 years at an average rate of about 6 percent per year. As a result, annual world merchandise trade has risen from \$84 billion in 1953 to \$16 trillion in

2016 (World Trade Organization 2017). Never before has international trade grown so rapidly for such a long period. Even more importantly, trade has consistently grown more rapidly than the world's economic output. Consequently, each year a greater proportion of the goods and services produced in the world are created in one country and consumed in another. Indeed, globalization is a consequence of these differential growth rates.

None of this has occurred spontaneously. Even though one could argue that the growth of world trade reflects the operation of global markets and the cost-reducing impact of telecommunications technology, all markets rest on political structures. This is certainly the case with international trade. World trade has grown so rapidly over the last 70 years because an international political structure, the **World Trade Organization (WTO)**, and its predecessor, the General Agreement on Tariffs and Trade (GATT), has supported and encouraged such growth. Most political scientists who study the global economy believe that, had governments never created this institutional framework after World War II, or had they created a different one, world trade would not have grown so rapidly. Internationalization, therefore, has been brought about by the decisions governments have made about the rules and institutions that govern world trade.

Because trade plays so important a role in our lives, and because trade is made possible by the political institution that structures trade relationships, understanding the political dynamics of the world trade system is vital. This chapter begins developing that knowledge. It provides a broad overview of the WTO's core components. It then examines how the global distribution of power shapes the creation and evolution of international trade systems. It then explores some contemporary challenges to the WTO, focusing on the rise of developing countries as a powerful bloc within the organization and the rise of civil society groups as powerful critics of the organization from the outside. The chapter concludes by examining regional trade arrangements, considered by many the greatest current challenge to the WTO.

WHAT IS THE WORLD TRADE ORGANIZATION?

The WTO (located on the shore of the beautiful Lac Lemman in Geneva, Switzerland) is the hub of an international political system under which governments negotiate, enforce, and revise rules to govern their trade policies. Between 1947 and 1994 the GATT fulfilled the role now played

by the WTO. In 1995, governments folded the GATT into the newly established WTO, where it continues to provide many of the rules governing international trade relations. The rules at the center of the world trade system were thus established initially in 1947 and have been gradually revised, amended, and extended ever since.

The WTO is small compared with other international organizations. Although 164 countries belong to the WTO, it has a staff of only about 640 people and a budget of roughly \$200 million (as of late 2017). The World Bank, by contrast, has a staff of about 10,000 people and an operating budget of close to \$2.5 billion. As the center of the world trade system, the WTO provides a forum for trade negotiations, administers the trade agreements that governments conclude, and provides a mechanism through which governments can resolve trade disputes. As a political system, the WTO can be broken down into three distinct components: a set of principles and rules, an intergovernmental bargaining process, and a dispute settlement mechanism.

Two core principles stand at the base of the WTO: market liberalism and nondiscrimination. **Market liberalism** provides the economic rationale for the trade system. Market liberalism asserts that an open, or liberal, international trade system raises the world's standard of living. Every country—no matter how poor or how rich—enjoys a higher standard of living with trade than it can achieve without trade. Moreover, the gains from trade are greatest—for each country and for the world as a whole—when goods can flow freely across national borders unimpeded by government-imposed barriers. The claim that trade provides such gains to all countries is based on economic theory we examine in detail in [Chapter 3](#). For our purposes here, it is sufficient to recognize that this claim provides the economic logic upon which the WTO is based.

Nondiscrimination is the second core principle of the multilateral trade system. Nondiscrimination ensures that each WTO member faces identical opportunities to trade with other WTO members. This principle takes two specific forms within the WTO. The first form, called **Most-Favored Nation** (MFN), prohibits governments from using trade policies to provide special advantages to some countries and not to others. MFN is found in Article I of GATT. It states,

any advantage, favour, privilege, or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

Stripped of this legal terminology, MFN simply requires each WTO member to treat all WTO members the same. For example, the United States cannot apply lower tariffs to goods imported from Brazil (a WTO member) than it applies to goods imported from other WTO member countries. If the United States reduces tariffs on goods imported from Brazil, it must extend these same tariff rates to all other WTO members. MFN thus assures that all countries have access to foreign markets on equal terms.

WTO rules do allow some exceptions to MFN. The most important exception concerns regional trade arrangements. Governments are allowed to depart from MFN if they join a free-trade area or customs union. In the North American Free Trade Agreement (NAFTA), for example, goods produced in Mexico enter the United States duty free, whereas the United States imposes tariffs on the same goods imported from other countries. In the European Union, goods produced in France enter Germany with a lower tariff than goods produced in the United States. A second exception is provided by the **Generalized System of Preferences (GSP)**, enacted in the late 1960s. The GSP allows the advanced industrialized countries to apply lower tariffs to imports from developing countries than they apply to the same goods coming from other advanced industrialized countries. These exceptions aside, MFN ensures that all countries trade on equal terms.

National treatment is the second form of nondiscrimination found in the WTO. **National treatment** prohibits governments from using taxes, regulations, and other domestic policies to provide an advantage to domestic firms at the expense of foreign firms. National treatment is found in Article III of the GATT, which states that

the products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

In plainer English, national treatment requires governments to treat domestic and foreign versions of the same product (“like products” in GATT terminology) identically once they enter the domestic market. For example, the U.S. government cannot establish one fuel efficiency standard for foreign cars and another for domestic cars. If the U.S. government wants to advance this environmental goal, it must apply the same requirement to domestic and foreign auto producers. Together, MFN

and national treatment ensure that firms in every country face the same market opportunities and barriers in the global economy.

These two core principles are accompanied by hundreds of other rules. Since 1947, governments have concluded about 60 distinct agreements that together fill about 30,000 pages. These rules jointly provide the central legal structure for international trade. As a group, these rules constrain the policies that governments can use to control the flow of goods, services, and technology into and out of their national economies. Some of these rules are proscriptive, such as prohibition against government discrimination. Others are prescriptive, such as requirements for governments to protect intellectual property. Many of these rules state instances in which governments are allowed to protect a domestic industry temporarily and then delineate the conditions under which governments can and cannot invoke this safeguard. All rules entail obligations to other WTO members that constrain the ability of governments to regulate the interaction between the national and the global economies.

All WTO rules are created by governments through intergovernmental bargaining. **Intergovernmental bargaining** is the WTO's primary decision-making process, and it involves negotiating agreements that directly liberalize trade and indirectly support that goal. To liberalize trade, governments must alter policies that restrict the cross-border flow of goods and services. Such policies include **tariffs**, which are taxes that governments impose on foreign goods entering the country. They also include a wide range of **non-tariff barriers** such as health and safety regulations, government purchasing practices, and many other government regulations. Intergovernmental bargaining focuses on negotiating agreements that reduce and eliminate these government-imposed barriers to market access.

Rather than bargain continuously, governments organize their negotiations in bargaining rounds, each with a definite starting date and a target date for conclusion. At the beginning of each round, governments meet as the WTO **Ministerial Conference**, the highest level of WTO decision making. Meeting for 3 or 4 days, governments establish an agenda detailing the issues that will be the focus of negotiation and set a target date for the conclusion of the round. Once the Ministerial Conference has ended, lower-level national officials conduct detailed negotiations on the topics embodied in the agenda. Periodic stock takings are held to reach interim agreements. Once negotiations have produced the outlines of a complete agreement, trade ministers meet at a final Ministerial Conference to conclude the round. National governments then

ratify the agreement and implement it according to an agreed timetable.

TABLE 2.1

Trade Negotiations within the General Agreement on Tariffs and Trade (GATT)/World Trade Organization (WTO), 1947–2018

Name and Year of Round	Subjects Covered	Participating Countries
1947 Geneva	Tariffs	23
1949 Annecy	Tariffs	13
1951 Torquay	Tariffs	38
1956 Geneva	Tariffs	26
1960–1961 Dillon Round	Tariffs	26
1964–1967 Kennedy Round	Tariffs and Antidumping	62
1973–1979 Tokyo Round	Tariffs	102
	Non-tariff Measures Framework Agreements	
1986–1993 Uruguay Round	Tariffs	123
	Non-tariff Measures Rules Services Intellectual Property Rights Textiles and Clothing Agriculture Dispute Settlement Establishment of WTO	
2002-? The Doha Round	Tariffs	147
	Agriculture Services Intellectual Property Rights	

Government
Procurement
Rules
Dispute Settlement
Trade and the
Environment
Competition Policy
Electronic Commerce
Other Issues

Source: World Trade Organization 1995, 9 and WTO website.

To date, eight of these bargaining rounds have been concluded, and a ninth, the **Doha Round**, began in 2001 (see [Table 2.1](#)). These bargaining rounds are usually extended affairs. Although the earlier rounds were typically concluded relatively quickly, the trend over the last 30 years has been for multiyear rounds. Governments launched the Uruguay Round, for example, in 1986 (though they began discussing a new round in 1982) and concluded negotiations in December 1993. Governments launched the Doha Round in 2001 with plans to conclude the round by late 2005. Yet, in late 2017, governments remain unable to reach agreement. The growing length of bargaining rounds reflects the complexity of the issues at the center of negotiations and the growing diversity of interests among WTO member governments.

The rules established by intergovernmental bargaining provide a framework of law for international trade relations. Participation in the WTO, therefore, requires governments to accept common rules that constrain their actions. By accepting these constraints, governments shift international trade relations from the anarchic international environment in which “might makes right” into a rule-based system in which governments have common rights and responsibilities. In this way, the multilateral trade system brings the rule of law into international trade relations.

A Closer Look

The Doha Round

We can gain a better understanding of WTO bargaining by examining the evolution of negotiations in the Doha Round. Governments launched the **Doha Round** at the WTO’s Fourth Ministerial

Conference held in Doha, Qatar, in November 2001. In Doha, governments reached agreement on the bargaining agenda: what issues they would address and which they would ignore. Governments agreed to (1) negotiate additional tariff reductions (with a specific focus on developing countries' exports), (2) incorporate existing negotiations in services into the Doha Round, and (3) pursue meaningful liberalization of trade in agricultural products. In agriculture, they agreed to reduce barriers to market access, to eliminate agricultural export subsidies, and to reduce domestic production subsidies. The agenda also called for negotiations on trade-related intellectual property rights, on modifications of existing WTO rules regarding anti-dumping and subsidies' investigations, and on the rules pertaining to regional trade agreements and review of the operation of the dispute-settlement mechanism. Moreover, governments agreed to explore aspects of the relationship between trade and the environment. Finally, members agreed to defer negotiations on trade and investment, competition policy, government procurement, and trade facilitation (four issues known collectively as "The Singapore Issues"). They agreed to treat the agenda as a "single undertaking," meaning that everything must be agreed or nothing is agreed.

The Doha Agenda was just that—an agenda for negotiations. It contained no details about the form an eventual final agreement would take. Negotiations between governments aimed at elaborating these details began at WTO headquarters in Geneva in early 2002. These initial negotiations (conducted for the most part by national delegations staffed by career civil servants or foreign service officers) were not oriented toward making final decisions, but instead explored areas of agreement and disagreement. These negotiations would set the stage for a stock-taking exercise scheduled for the WTO's Fifth Ministerial Conference in Cancún, Mexico, in September of 2003. Even though much of the work proceeded smoothly, it quickly became evident that two issues posed large obstacles. First, developing countries were demanding deeper liberalization of agriculture than the United States and the European Union (EU) were willing to accept. Second, the EU was insisting that negotiations on the Singapore issues be initiated in 2004, but developing countries were unwilling to negotiate on new issues until they had achieved substantial gains in agriculture. In the late summer of 2003, negotiations in Geneva paused as governments prepared for the Cancún Ministerial Conference.

As trade ministers gathered in Cancún in September 2003, they

hoped to achieve two broad goals that would push the Doha Round into the home stretch. The first was to bridge the gap concerning agriculture and the Singapore issues. Governments hoped this would be possible in Cancún because trade ministers had the political authority that lower-level officials lacked to make substantial concessions. A simple compromise appeared possible: the United States and the EU would accept substantial liberalization in agriculture, and the developing countries would allow negotiations on some of the Singapore issues. Second, once they had removed this major obstacle, governments would agree on a broad framework for the final agreement. The Geneva-based delegations would then work out the precise details during the following year, and the final agreement would be concluded at the next Ministerial Conference scheduled for Hong Kong in December 2005. Neither goal was achieved. The EU and the United States were unwilling to meet the developing countries' demands regarding agriculture, and the developing countries refused to allow negotiations on the Singapore issues. Unable to reach agreement, the Cancún Ministerial Conference adjourned with negotiations in complete disarray.

It took almost a year to put the negotiations back on track. Finally, on August 1, 2004, governments reached the agreement that had eluded them in Cancún. The EU and the United States accepted broad principles concerning the liberalization of trade in agriculture. In exchange, developing countries agreed to negotiating one of the Singapore issues: trade facilitation. Members hoped that this agreement would allow them to finish negotiations in time to complete the round at the Hong Kong Ministerial in December 2005. Negotiations progressed slowly, however, as it proved difficult to translate these broad principles into meaningful tariff and subsidy reductions. As a consequence, when governments arrived in Hong Kong in December 2005 there was little chance they would conclude the round. Instead, governments reached a few specific agreements at the Hong Kong Ministerial (the EU agreed to eliminate agricultural export subsidies by 2013; the advanced industrialized countries agreed to eliminate 97 percent of the tariffs on exports of the least developed countries), and they accepted a work program intended to conclude the round by the end of 2006.

Governments ended the Doha Round 9 years later without reaching an overarching agreement. At the 10th WTO Ministerial Conference held in Nairobi, Kenya, members reached limited agreements on

agriculture, on trade facilitation, and on information technology, and put aside the broader and more ambitious Doha agenda. Failure has many fathers, but in the case of the Doha Round, the principal culprit was Father Time. As Michael Froman, who was then the United States Trade Representative, argued: “Doha was designed in a different era, for a different era, and much has changed since.” It was time “for the world to free itself of the strictures of Doha” in order to make progress along other tracks (Froman 2015). The specific reasons for Doha’s failure, which we will look at later in this chapter, raise questions about the role the WTO can play in the international trade system moving forward.

The WTO’s **dispute settlement mechanism** ensures that governments comply with the rules they establish. Individual compliance with established rules is not guaranteed. Even though most governments comply with most of their WTO obligations most of the time, there are times when some don’t. Moreover, if all governments believed they could disregard WTO rules with impunity, they would comply less often. The dispute settlement mechanism ensures compliance by helping governments resolve disputes and by authorizing punishment in the event of noncompliance.

The dispute-settlement mechanism ensures compliance by providing an independent quasi-judicial tribunal. This tribunal investigates the facts and the relevant WTO rules whenever a dispute is initiated and then reaches a finding. A government found to be in violation is required to alter the offending policy or to compensate the country or countries that are harmed. We will examine the dispute settlement mechanism in greater detail in [Chapter 3](#).

The WTO, therefore, is an international political system that regulates national trade policies. It is based on rules that constrain what governments can do to restrict the flow of goods into their countries and to encourage the export of domestic goods to foreign markets. All of these rules have been created (and can be amended) through intergovernmental bargaining. Because compliance with the rules cannot be taken for granted, governments have established a dispute-settlement mechanism to help ensure that members comply. By creating rules, establishing a decision-making process to extend and revise them, and enforcing compliance, governments have brought the rule of law into international trade relations.

HEGEMONS, PUBLIC GOODS, AND THE WORLD TRADE SYSTEM

The stability of the WTO, and of international trade systems more broadly, is a function of the distribution of power in the international system. In particular, **hegemonic stability theory** is often advanced to explain why the system shifts between periods in which it is open and liberal, and periods in which it is closed and discriminatory.

Hegemonic stability theory rests on the logic of public goods provision. A **public good** is defined by two characteristics: non-excludability and non-rivalry. Non-excludability means that once the good has been supplied, no one can be prevented from enjoying its benefits. A lighthouse, for example, warns captains away from a nearby coast. Once that beacon is lit, no captain can be prevented from observing the light and avoiding the coast. Non-rivalry means that consumption by one individual does not diminish the quantity of the good available to others. No matter how many captains have already consumed the light, it remains just as visible to the next captain.

Public goods tend to be undersupplied relative to the value society places upon them. Undersupply is a result of a phenomenon called free riding. **Free riding** describes situations in which individuals rely on others to pay for a public good (Sandler 1992, 17). My experience with public radio illustrates the logic. My local public radio station uses voluntary contributions from its listeners and businesses to finance 87 percent of its budget. Without these voluntary contributions, the station would go off the air. As a regular listener, I benefit immensely from the station's existence, and my life would be greatly diminished were the station shut down. Yet, I have never contributed to the station. Instead, I rely upon others to pay for the station's operations. In other words, I free ride on other listeners' contributions. Because everyone faces the same incentive structure, contributions to the station are lower than they would be if non-contributors could be denied access to public radio. More broadly, goods that are non-excludable and non-rivalrous tend to be undersupplied.

The severity of the free-riding problem is partly a function of the size of the group. In large groups, each individual contribution is very small relative to the total contribution, and as a result each individual has only a small impact on the ability of the group to achieve its objective. Consequently, each individual readily concludes that the group can succeed without his contribution. In large groups, therefore, the incentive to free ride is very strong. In small groups, sometimes called "privileged

groups,” each individual contribution is large relative to the total contribution, and therefore each contribution has a greater impact on the group’s ability to achieve its common goal. It becomes more difficult for any individual to conclude that the group can succeed without his contribution. As a result, the incentive to free ride is weaker (though not altogether absent) in small groups.

International institutions such as the WTO have public good characteristics. International rules and procedures benefit all governments (though not necessarily all benefit equally). Moreover, it is difficult (though not impossible) to deny a government these benefits once an institution has been established. Moreover, these benefits do not decrease as a function of the number of governments that belong to the institution. Because international institutions have these public good characteristics, their provision can be frustrated by free riding. All governments want global trade rules, but each wants someone else to bear the cost of providing such rules.

Hegemonic stability theory argues that hegemonies act like privileged groups and thus overcome the free-riding problem. A **hegemon** is a country that produces a disproportionately large share of the world’s total output and that leads in the development of new technologies. Because it is so large and technologically advanced, the benefits that the hegemon gains from trade are so large that it is willing to bear the full cost of creating international trade rules. Moreover, the hegemon recognizes that the public good will not be provided in the absence of its contribution. Hence, the free-riding problem largely disappears, and stable regimes are established, during periods of hegemonic leadership. As a hegemon declines in power, it becomes less willing to bear the cost of maintaining trade rules, and world trade becomes less open.

Historical evidence provides some support for hegemonic stability theory, as world trade has flourished during periods of hegemonic leadership and floundered during periods without it. The two periods of rapid growth of world trade occurred under periods of clear hegemony. Great Britain was by far the world’s largest and most innovative economy throughout the nineteenth century. Trade within Europe and between Europe and the rest of the world grew at what were then unprecedented rates. British hegemony, therefore, created and sustained an open, liberal, and highly stable global economy in which goods, capital, and labor flowed freely across borders. The same relationship is evident in the twentieth century. The United States exited World War II as an undisputed hegemon. It played the leading role in creating the GATT, and it led the

push for negotiations that progressively eliminated barriers to trade. The result was the most rapid increase in world trade in history. Hence, the two hegemonic eras are characterized by stable trade regimes and the rapid growth of international trade.

The one instance of hegemonic transition is associated with the collapse of the world trade system. The transition from British to American hegemony occurred in the early twentieth century. In 1820, the American economy was only one-third the size of Great Britain's. By 1870, the two economies were roughly the same size. On the eve of World War I, the American economy was more than twice as large as Great Britain's (Maddison 2001, 261). By the end of World War II, the United States produced almost half of the world's manufactured goods (see [Table 2.2](#)). During this transition, each looked to the other to bear the cost of reconstructing the global economy after World War I. The British tried to reconstruct the world economy in the 1920s, but lacked the resources to do so (Kindleberger 1974). The United States had the ability to re-establish a liberal world economy, but wasn't willing to expend the necessary resources. Consequently, the Great Depression sparked the profusion of discriminatory and protectionist trade blocs. As protectionism rose, world trade fell sharply (see [Table 2.3](#)). Hence, hegemonic transition has been associated with considerable instability of international trade.

TABLE 2.2

Shares of World Manufacturing Production (Percent)

	1880	1900	1913	1928
United States	14.7	23.6	32.0	39.3
Great Britain	22.9	18.5	13.6	9.9
Germany	8.5	13.2	14.8	11.6
France	7.8	6.8	6.1	6.0

Source: Kennedy 1988, 259.

TABLE 2.3

Collapse of World Trade

(Average Monthly World Trade, \$U.S. millions)

1929	2,858
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1930	2,327
1931	1,668
1932	1,122

Source: Kindleberger 1974, 140.

Although these episodes are suggestive, they are too few to support strong conclusions about the relationship between hegemony and international trade. This empirical limitation is of more than pure academic interest, given the emergence of China and India as powerful forces in the global economy. China's emergence, in particular, raises questions about whether we are witnessing a hegemonic transition. Goldman Sachs estimates that China will overtake the United States in total economic production by 2027. Christopher Layne asserts that "economically, it is already doubtful that the United States is still a hegemon" (Layne 2009, 170).

These contemporary developments find parallels in the recent past. During the 1960s, the Japanese economy grew at average annual rates of more than 10 percent, compared with average growth rates of less than 4 percent for the United States. Although Japanese growth slowed during the 1970s and 1980s, Japan continued to grow more rapidly than the United States. Faster growth allowed Japan to catch up with the United States. In the early 1960s, the United States produced 40 percent of the world's manufactured goods, whereas Japan produced only 5.5 percent. By 1987, the United States' share of world manufacturing production had fallen to 24 percent, whereas Japan's share had increased to 19.4 percent (Dicken 1998, 28). In less than 30 years, therefore, Japan transformed itself from a vanquished nation into a powerful force in the world economy.

Many commentators viewed Japan's ascent as a harbinger of hegemonic decline. The United States began running trade deficits in the 1970s, and these deficits continued to grow during the 1980s. American policymakers interpreted these deficits as evidence of declining competitiveness, particularly in high-technology industries. Measures of the United States' comparative advantage in high-technology industries suggested that it was losing ground in critical sectors such as mechanical equipment, electronics, scientific instruments, and commercial aircraft. And what the United States appeared to be losing, Japan appeared to be gaining. Statistics suggested that as the American share of global high-technology markets fell (from 30 percent to 21 percent between 1970 and 1989),

Japan's share of this market rose (from 7 percent to 16 percent in the same period) (Tyson 1995, 19). Thus, the trade deficit and the apparent decline in American high-technology industries both pointed to the same conclusion: the United States was losing ground to Japan.

The United States responded to these developments by adopting a more aggressive and protectionist trade policy: it increasingly relied on bilateral initiatives and threatened to protect the American market to force changes in other countries' trade policies (Krueger 1995). Japan was the principal (though not the sole) target of American assertiveness. Many analysts argued that this assertiveness reflected "the syndrome of hegemonic decline." Some argued that the protectionist tendencies generated by hegemonic decline would be reinforced by the end of the Cold War, which deprived the United States of a broader purpose provided by the alliance against the Soviet threat. Robert Gilpin, a political economist at Princeton University, summarized this pessimistic outlook, arguing that "at the opening of the twenty-first century, all the elements that have supported an open global economy have weakened" (Gilpin 2000, 347).

Assertions of hegemonic decline proved premature, however. American unilateralism subsided in the mid-1990s as the United States entered a period of sustained robust growth and Japan struggled to recover from a financial and banking crisis. In this decade, governments strengthened and extended the multilateral trade system. They established the WTO, which enjoyed greater support and attracted a larger membership than the GATT did at the height of American hegemony. As one analyst concluded in looking back on the predictions of hegemonic decline, "the institutions that took hold after World War II continue to provide governance now, and the economic interests and political consensus that lie behind them are more, not less, supportive of an open world economy today than during the Cold War" (Ikenberry 2000, 151).

The open question, therefore, is whether China's emergence today is a hegemonic transition like that which occurred during the early twentieth century or a false alarm like that prompted by Japan during the 1980s. That is, is the global system transitioning from the American century to the Asian century, or will Asia's ascent level off? Moreover, if we are experiencing hegemonic transition, must the global trade system weaken and collapse as it did during the 1920s and 1930s? Might the institutional structures constructed under American leadership help governments transition to a new global power structure without suffering another economic "dark age"?

THE EVOLVING WORLD TRADE ORGANIZATION: NEW DIRECTIONS, NEW CHALLENGES

Although the trade system's core principles and procedures have been stable for roughly 70 years, the past few years have brought substantial change. These changes will probably shape the evolution of the system over the next decade. Two such changes are most important: the emergence of developing countries as a powerful bloc within the organization, and the emergence of NGOs as a powerful force outside the organization. Together these developments have complicated decision making within the WTO and raised fundamental questions about the ability of governments to continue to achieve their goals through the system.

The first substantial change in the WTO arises from the growing power of developing countries within the organization. WTO membership has expanded dramatically since 1985. More than 70 countries have joined, increasing total membership to 164 countries (as of October 2017). Still more countries have applied for membership and are currently engaged in accession negotiations. Assuming all these negotiations are successfully completed, WTO membership will surpass 190 countries during the next few years. Even if all governments have similar interests, more members will make the decision making harder—it is very difficult to gain consensus among 164 countries.

Membership growth reflects the dramatic reorientation of emerging market countries toward international trade. For reasons we explore in greater detail in [Chapter 6](#), governments in most developing countries were skeptical about the ability to foster development through trade. Consequently, most governments participated little in the GATT system. And to the extent that developing countries belonged to the GATT, the industrialized countries accorded them special treatment rather than demanding strict reciprocity. The GATT became, as a result, a rich-country club in which negotiations focused on the areas of interest to the United States, the EU, and Japan, and neglected liberalization in areas of interest to developing countries. Since the mid-1980s, emerging market countries have emphasized development through exports and, as a result, have placed substantially greater importance on the market access that participation in the WTO provides.

Under the leadership of the three largest emerging economies, Brazil, China, and India, developing-country members have constructed a

powerful bloc within the WTO. This power has been evident in the past decade. Developing countries stymied the first effort to launch the current round of negotiations in Seattle in 1999 because the proposed agenda dedicated too much attention to issues of interest to the United States and the EU and insufficient attention to the issues developing countries believed important. The current round launched once developing countries were satisfied that the agenda focused sufficient attention on the topics of importance to them, especially liberalization of agriculture and maintaining sufficient policy space to promote development. Since 2003, cooperation among developing countries within the WTO has been institutionalized in the Group of 20.

The emergence of the developing countries as a powerful bloc in the WTO has transformed bargaining. In previous rounds countries with similar economic structures exchanged roughly equivalent concessions. With developing countries on the sidelines, the United States, the EU, and Japan defined the negotiating agenda. As a result, governments liberalized industries in which they all enjoyed relative competitiveness, generally capital-intensive manufactured goods, and continued to protect industries in which they were uncompetitive. Labor-intensive industries and farming thus remained protected in most industrialized countries. In essence, the United States, the EU, and Japan agreed to allow GM, Toyota, and Volkswagen to compete against each other in all three markets. Reducing these barriers challenged national producers in each country by exposing them to global competition, but because all countries were roughly similar in structure, liberalization did not impose substantial adjustment costs.

Current WTO bargaining brings together governments representing countries with very different economic structures. Industrialized countries who are competitive in high-technology products and services bargain with developing countries who are competitive in labor-intensive manufactured goods, in standardized capital-intensive goods such as steel, and in agriculture. For negotiations to succeed, governments in each group must liberalize industries that will not survive full exposure to international competition. As a result, a broad agreement such as that which would have been necessary to conclude the Doha Round would impose hefty adjustment costs, in agriculture for many European Union countries, Japan, the United States, and other developed countries, and in services and manufactured goods for most developing countries.

Changes inside the organization are compounded by changes outside. Of particular importance here is the growing number of nongovernmental organizations (NGOs) striving to influence the organization. Few interest

groups (other than businesses) paid much attention to the GATT when negotiations focused solely on tariffs. Since the late 1990s, however, hundreds of groups have mobilized in opposition to what they view as the unwelcome constraints imposed by new WTO rules. In many instances, NGOs worry about how WTO rules affect the ability of governments to safeguard consumer and environmental interests.

WTO rules do not prevent governments from protecting consumers from unsafe foods or protecting the environment from clear hazards. For example, when cattle stricken by mad cow disease were discovered in the United States, nothing in the WTO prohibited other governments from banning the import of American beef. Similarly, when U.S. inspectors found toxic chemicals in toothpaste manufactured in China, WTO rules did not prohibit the United States from banning imports of the afflicted product. Problems arise when governments use health or environmental concerns as an excuse to shelter domestic producers from foreign competition. Such practices can become common in a world in which governments cannot use tariffs to protect industry. Suppose the United States wants to protect American avocado growers from competition against cheaper Mexican avocados, and so assert that Mexican avocados contain pests that harm American plants (even though they don't) and on this basis ban Mexican avocados from the American market. This is disguised protectionism—an effort to protect a local producer against foreign competition, hidden as an attempt to protect plant health in the United States.

WTO agreements, such as the Agreement on Sanitary and Phytosanitary Standards, attempt to strike a balance between allowing governments to protect against legitimate health risks and preventing governments from using such regulations to protect domestic producers. This is a difficult balance to strike. It is not easy to determine the real motives behind a government's decision to ban imports of a particular product. Did the EU ban the import of hormone-treated beef because of a sincere concern about potential health consequences or to protect European beef producers from American competition? As a consequence, WTO rules require governments to accept current scientific conclusions about the risks to humans, animals, and plants that such products pose. Governments cannot ban imports of a product on health or safety grounds unless a preponderance of scientific evidence indicates that the product is in fact harmful. Such rules extend deeply into an aspect of national authority: the ability to determine what risks society should be exposed to and protected from.

Civil society groups argue that the balance struck by current WTO rules is too favorable to business and insufficiently protective of consumer and environmental interests. Moreover, they argue that the bias toward producer interests is a consequence of the nature of the WTO decision making, a process in which producer interests are heavily represented and consumer interests are almost entirely excluded. The mobilization of NGOs around the WTO has thus sought to bring greater attention to consumer interests in order to redress this perceived imbalance.

The growing power of developing countries within the WTO and the greater pressure by NGOs on the outside of the organization have combined to generate questions about whether the WTO can remain relevant under its current decision-making procedures. One dimension of this question concerns effectiveness: Can 164 governments at different stages of economic development reach agreements that provide meaningful trade liberalization? The failure to reach a broad agreement in the Doha Round highlights the limited effectiveness of consensus-based bargaining among so many states. A second dimension concerns legitimacy: Should rules that constrain national regulations be negotiated without the full participation of civil society?

Both dimensions matter, but they point to contradictory conclusions. Concerns about the effectiveness of WTO negotiations highlight the need for reform that limits the number of governments actively participating in negotiations. One such proposal advocates the creation of a steering committee, a WTO equivalent of the United Nations Security Council, with authority to develop consensus on trade issues (see Schott and Watal 2000). Such reform would make it easier to reach agreement, but only by making negotiations less inclusive. Concerns about legitimacy highlight the need for reform that opens the WTO process to NGOs. Opening the WTO in this manner, NGOs argue, would ensure that business interests are balanced against other social concerns. Although such reforms might make WTO decision making more inclusive, they would also make it even more difficult to reach agreement within the organization.

Dissatisfaction with current decision-making procedures has yet to produce a consensus about whether and how to change current procedures. The most important consequence of the impasse that prevented major gains in the Doha Round, therefore, has been that governments have found the WTO increasingly less useful as a forum within which to pursue their trade objectives. And as they have reached this conclusion, they have begun to seek alternatives that can be more effective.

THE GREATEST CHALLENGE? REGIONAL TRADE ARRANGEMENTS AND THE WORLD TRADE ORGANIZATION

Regionalism is one alternative that has gained particular appeal. Indeed, many observers believe that regional trade arrangements pose the single greatest challenge to the multilateral trade system. Regional trade arrangements pose a challenge to the WTO because they offer an alternative, and often more discriminatory, way to organize world trade.

A **regional trade arrangement (RTA)** is a trade agreement between two or more countries, usually located in the same region of the world, in which each country offers preferential market access to the other. RTAs come in two basic forms: free-trade areas and customs unions. In a **free-trade area**, like the North American Free Trade Agreement, governments eliminate tariffs on other members' goods, but each member retains independent tariffs on goods entering their market from non-members. In a **customs union**, like the EU, member governments eliminate all tariffs on trade between customs union members and impose a common tariff on goods entering the union from non-members.

Because RTAs provide tariff-free market access to some countries, but not to others, they are inherently discriminatory. Though such discrimination is inconsistent with the GATT's core principle, GATT's Article XXIV allows countries to form RTAs as long as the level of protection imposed against nonmembers is no higher than the level of protection applied by the countries prior to forming the arrangement. Nevertheless, the discriminatory aspect of RTAs makes many worry about the impact they will have on the nondiscriminatory trade encouraged by the WTO.

Such worries arise because of the rapid proliferation of RTAs. According to the WTO, there are currently 279 RTAs in operation. If all RTAs now planned are created, there may be as many as 445 RTAs in effect. Free-trade agreements constitute the vast majority of these RTAs, for 86 percent of existing RTAs and for 99 percent of arrangements currently being negotiated. More than half of all RTAs are bilateral agreements. The others are "plurilateral" agreements that include at least three countries. RTAs are densely concentrated in Europe and the Mediterranean region. Agreements between countries in Western, Eastern, and Central Europe, and in the Mediterranean account for almost 50 percent of RTAs in operation. North and South America take second place, accounting for about 12 percent. Until quite recently, sub-Saharan Africa

and Asia-Pacific states have joined few RTAs.

RTAs have emerged in three distinct waves (see Figure 2.1). The first wave began early in the 1950s and extended to the mid-1970s. This wave began with the construction of the original European Economic Community in 1958 and the Latin American Free Trade Area in 1960, and concluded with the formation of the Economic Community of West African States in 1975. This wave was motivated in part by a desire to promote deeper economic cooperation within particular regions in an attempt to promote peace and achieve more rapid economic development. In this regard, the contribution of the EEC to Franco-German political reconciliation after World War II and to rapid postwar economic recovery encouraged governments in other regions to emulate the approach. This early enthusiasm waned, however, as the economic gains realized in Europe did not materialize in the so-called developing world imitators.

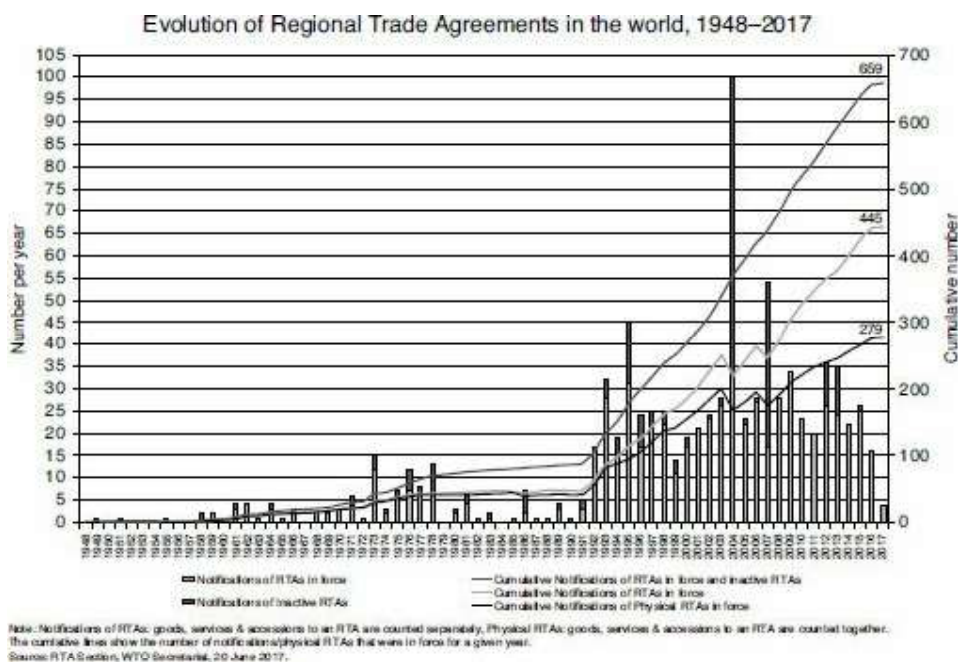


FIGURE 2.1

Regional Trade Arrangements, 1950–2016

Source: The World Trade Organization, WTO Secretariat, RTA Section, 20 June 2017.

The second wave began in the context of far-reaching trade policy reforms in Eastern and Central Europe, the former Soviet Union, and other developing countries. Governments in former members of the Soviet Bloc, for instance, sought new ways to organize their trade, and sought access to Western European markets. Consequently, a large number of agreements were reached between countries within the region and between these

countries and the EU (WTO 2000). Moldova, for example, entered RTAs with eight other newly independent countries formed from the former Soviet Union between 1992 and 1996. Russia entered at least nine RTAs with this same set of countries. Ten Eastern and Central European countries reached bilateral RTAs with the European Union between 1991 and 1997. There were also substantial changes in developing-country trade policies in the late 1980s and early 1990s, which led to a greater willingness to enter RTAs (WTO 2000). Mexico, for example, negotiated RTAs not only with the United States and Canada (NAFTA), but also with Chile, Costa Rica, and Nicaragua. Chile negotiated RTAs with Colombia, Ecuador, and Peru, in addition to completing the agreement it reached with Mexico.

The third wave began in 2008 or so and has been closely associated with the so-called **mega-regional agreements**. The two most prominent of these mega-regional agreements are the Trans-Pacific Partnership (TPP), negotiated between the U.S. and the EU, and the Transatlantic Trade and Investment Partnership (TTIP), which was negotiated by 13 states in Asia and North and South America. A third mega-regional, the Regional Comprehensive Economic Partnership, ties China to 15 other economies throughout Asia and the Pacific. In contrast to previous waves, which tended to focus most heavily on trade liberalization, the mega-regional agreements seek deeper economic integration among their members. To achieve this goal, these agreements are both broader in scope and reach more deeply into domestic arrangements than prior agreements. The TTIP and the TPP were intended to promote cooperation and harmonization on technical barriers to trade, which are domestic rules, regulations, and administrative procedures that can limit trade flows. In addition, these agreements included trade in services, more ambitious rules regarding the protection of intellectual property than are present in the WTO and agreement on the treatment and protection of foreign investment. The TPP included most of these issues as well as an elaborate and enforceable code on labor standards.

Why have RTAs proliferated, especially since 1990? Scholars have advanced a number of general explanations for this trend. Some emphasize a country's desire to gain more secure access to the market of a particularly important trading partner. In the U.S.–Canada Free Trade Agreement concluded in the late 1980s, for example, Canada sought secure access to the U.S. market—the most important destination for Canada's exports. During much of the 1980s, the United States made frequent use of anti-dumping and countervailing duty investigations to

protect American producers from Canadian imports. Such measures clearly interfered with the ability of Canadian producers to export to the American market. The Canadian government hoped that the U.S.–Canada Free Trade Agreement would give Canada “some degree of exemption” from these measures (Whalley 1998, 72–73).

Other scholars emphasize a government’s need to signal a strong commitment to economic reform. Governments use RTAs to convince foreign partners that they will maintain open markets and investor-friendly policies. This argument has been applied most commonly to Mexico’s decision to seek a free-trade agreement with the United States. Mexico shifted from a highly protectionist to a more liberal trade policy in the mid-1980s. The success of that strategy hinged in part on Mexico’s ability to attract foreign investment from the United States. The Mexican government feared, however, that American investors would not believe that the Mexican government was committed to its new strategy. What would prevent Mexico from shifting back to protectionism and nationalizing foreign investments? If American businesses didn’t believe the Mexican government was committed to this liberal strategy, they would be reluctant to invest in Mexico. Absent American investment, Mexico would be deprived of foreign capital that was critical to the success of its strategy.

A free-trade agreement with the United States allowed Mexico to signal to American investors the depth of its commitment to market liberalization. It did so in part because NAFTA contained very clear and enforceable rules concerning the treatment of foreign investment located in Mexico. A similar argument might be used to understand at least part of the interest that Eastern and Central European governments had in signing free-trade agreements with the EU. These governments were also reorienting their economic policies and were trying to attract foreign investment. Like Mexico, they might have needed an external institution, such as an agreement with the EU, to signal to foreign investors their commitment to market reforms. Notice that these arguments actually place less emphasis on the trade benefits that might result from an RTA and focus more on the need to attract foreign investment.

Other scholars argue that countries enter RTAs to increase their bargaining power in multilateral trade negotiations. A small country bargaining individually in the WTO lacks power because it does not have a large market to offer. By pooling a group of small countries, the market that can be offered to trade partners in WTO negotiations increases substantially. Consequently, each member might gain larger tariff

concessions in WTO negotiations. Current American enthusiasm for RTAs might also be seen as an attempt to gain bargaining power in the WTO. As it has become more difficult to reach decisions within the WTO, the United States has explicitly threatened to rely more on free-trade agreements. By doing so, the United States denies its market to countries unwilling to make concessions in the WTO. The fear of losing access to the U.S. market could induce governments to make concessions in the WTO that they would not otherwise make. The threat to rely more on RTAs and less on the WTO, therefore, enhances American power in the organization.

Finally, and clearly relevant to the emergence of the mega-regional agreements, the impasse in the Doha Round encouraged states to find other paths along which to pursue their trade policy goals. These agreements have enabled the EU, the U.S., Canada, Mexico, and South American countries with Pacific ties, as well as a few partners in Asia to pursue economic integration on issues of common interest and concern that they could not address in the WTO, given the resistance by many members to the initiation of negotiations on new issues. Digital trade, for instance, which is commerce in products that are delivered via the Internet (such as music, video, apps, e-books, etc), constitutes an important and growing share of the global economy and international trade. Current estimates indicate that its total value is \$4.2 trillion worldwide (U.S. International Trade Commission 2013). Yet, in spite of its growing importance, the issue was kept out of the Doha Round. Within the mega-regionals, governments could negotiate extensive rules to govern this trade. Moreover, the growing importance of global value chains has provided multinational businesses with a strong incentive to pressure their governments to negotiate these deeper agreements in order to better protect their investments, to harmonize product standards across national markets, and to make it easier and cheaper to ship goods across national boundaries (Baldwin 2014).

The rapid growth of RTAs raises questions about whether they challenge or complement the WTO. This is not an easy question to answer. On the one hand, RTAs liberalize trade, a mission they share with the WTO. In this regard, RTAs complement the WTO. On the other hand, RTAs institutionalize discrimination within world trade. In this regard, RTAs challenge the WTO.

Economists conceptualize these competing consequences of RTAs as **trade creation** and **trade diversion**. Consider an RTA between France and Germany. Because the RTA eliminates tariffs on trade between France

and Germany, more Franco-German trade takes place. This is trade creation. Because the RTA does not eliminate tariffs on trade between France and Germany on the one hand, and the United States on the other, some trade between the United States and Germany is replaced by trade between France and Germany. This is trade diversion. An RTA's net impact on trade is the difference between the trade it creates and the trade it diverts. If more trade is created than diverted, the RTA has liberalized trade. If more trade is diverted than created, the RTA has pushed the world toward protectionism.

Which of these effects predominates in existing RTAs? Nobody really knows, in large part because it is difficult to evaluate trade creation and trade diversion empirically. It is especially difficult once we begin to think about how RTAs evolve once created. An RTA that originally diverts more trade than it creates might over time create more trade than it diverts. Or an RTA could evolve in the opposite direction. Consider the first case. Some scholars have argued that RTAs exert a kind of gravitational force on countries that are not currently members. Countries that do not belong to the EU, but that engage in lots of trade with it, have a strong incentive to join. So it is no surprise, therefore, that over the last 40 years the EU has expanded from six to 25 member countries. Some see a similar dynamic at work in the Western Hemisphere. Mexico's decision to seek a free-trade agreement with the United States was at least partially motivated by concerns about the cost of being outside a U.S.–Canada Free Trade Area that had been negotiated in the late 1980s (Gruber 2000). The interest of many Latin American countries in a Free Trade Area of the Americas (FTAA) is at least partially a consequence of Mexico's entry into NAFTA (Baldwin 1995). Over time, this gravitational pull attracts so many additional members that a regional RTA evolves into a global free-trade area. In this optimistic scenario, RTAs lead eventually to global free trade in which trade creation outweighs trade diversion and RTAs complement the WTO.

Policy Analysis and Debate

The United States and the TPP

Question

Should the United States embrace aggressive bilateralism?

Overview

The Trump administration appears committed to a strategy of aggressive bilateralism in its trade relationships with the rest of the world. In its first major outline of trade policy, submitted to Congress in March 2017, the USTR stated that the guiding principle for its policy was to “expand trade in a way that is freer and fairer for all Americans.” And it stated that this goal “can be best accomplished by focusing on bilateral trade negotiations rather than multilateral negotiations—and by renegotiating and revising trade agreements” when necessary. Consequently, one of the first steps the Trump administration took upon entering office was to withdraw the U.S. from the TPP. In April of 2017, President Trump called the WTO “another one of our disasters” and ordered the Department of Commerce to undertake an extensive review of WTO rules. One month later, the administration notified Congress of its intention to renegotiate NAFTA, and in September 2017, Trump and other administration officials began to speak publicly about scrapping the U.S.–South Korea Free Trade Agreement. At present, the administration has wavered on its orientation toward TTIP and has yet to state publicly whether it intends to withdraw from this agreement as well.

The administration’s stated rationale for these changes is twofold. First, members of the administration assert that existing trade agreements between the United States and other countries put the U.S. at an “unfair advantage in global markets” (USTR 2017). Foreign governments enact unfair trade policies and practices such as subsidies, piracy of intellectual property, and currency manipulation that “harm American workers, farmers, ranchers, services providers, and other businesses” (ibid). And the WTO and other international enforcement mechanisms do not permit the U.S. to take steps to punish such transgressions. Second, the administration asserts that it can negotiate a series of bilateral trade agreements that prevent these unfair practices. It intends to use these bilateral negotiations to “hold our trading partners to higher standards of fairness” and will use American trade law “in response to trading partners that continue to engage in unfair activities.”

Policy Options

- The United States should retain its postwar policy based on multilateral cooperation within the WTO supplemented by regional trade agreements.
- The United States should be more aggressive in its trade relationships and the shift to bilateralism is a good way to implement such an approach.

Policy Analysis

- Does the United States derive benefits from the mega-regionals and the WTO that it cannot otherwise enjoy?
- How disadvantaged are American producers by unfair trade practices?

Take a Position

- Which option do you prefer? Justify your choice.
- What criticisms of your position should you anticipate? How would you defend your recommendation against these criticisms?

Resources

Online: Visit the U.S. Trade Representative website (www.ustr.gov) for timely information about current negotiations. The fullest statement of the Trump administration's approach is in the USTR's "The President's 2017 Trade Policy Agenda," which you can find at the Resource Center at [USTR.gov](http://ustr.gov)

In Print: See Jeffrey J. Schott, *US Trade Policy Options in the Pacific Basin: Bigger is Better*, PB17-7 (Washington, DC: Peterson Institute for International Economics, 2017); Doug Irwin, 2017, "The False Promise of Protectionism," *Foreign Affairs* 96 (May/June): 45–56.

By contrast, the creation of a large RTA in one region could encourage the formation of rival and more protectionist RTAs in other regions. In this scenario, NAFTA as well as FTAA could be seen as an American response to the EU. An emerging free-trade area in Pacific Asia could be seen as a response to regionalism in Europe and the Western Hemisphere. In this view, world trade is becoming increasingly organized into three regional

and rival trade blocs. Once regional trading blocs have formed, each bloc might raise tariffs to restrict trade with other regions. A tariff increase by one RTA could provoke retaliation by the others, leading to a rising spiral of protection that undermines global trade liberalization (Frankel 1997, 210). In this case, trade diversion outweighs trade creation and RTAs pose an obvious challenge to the WTO.

It is impossible to predict which of these two scenarios is the more likely. The world does seem to be moving toward three RTAs: one in Europe, one in the Western Hemisphere, and one in Asia. At the same time, governments appear to be aware of the challenges RTAs pose to the WTO, as they have created a WTO committee on RTAs that is exploring the relationship between these arrangements and the multilateral system. Only time will tell, however, whether RTAs will develop into discriminatory trade blocs that engage in tariff wars or if instead they will pave the way for global free trade.

CONCLUSION

The multilateral trade system is an international political system. It provides rules that regulate how governments can use policies to influence the cross-border flow of goods and services. It provides a decision-making process through which governments revise existing rules and create new ones. And it provides a dispute-settlement mechanism that allows governments to enforce common rules. By promoting nondiscriminatory international trade, by establishing a formal process for making and revising rules, and by allowing governments to enforce the rules they create, the WTO reduces the impact of raw power on international trade relationships. In short, the WTO brings the rule of law to bear in international trade relations.

Like all political systems, the WTO reflects the interests of the powerful. Its creation reflected the interests of a hegemonic United States; its strengthening during the Cold War era reflected the growing interest of European and Japanese governments that trade liberalization promised real gains. Although one can argue that the WTO reflects only the interests of the advanced industrialized countries, the trends over the last 20 years suggest otherwise. The rapid growth in the number of countries joining the WTO during that period suggests that most of the world's governments believe that they are better off with the WTO than without it. This doesn't mean that the system is perfect. It does suggest, however, that in the contemporary global economy, the majority of the world's governments

believe that they do better when world trade is organized by a system based on nondiscrimination and market liberalism than they do in a discriminatory, protectionist, and rule-free environment. The WTO will weaken, and perhaps even crumble, when governments no longer believe this is true.

The largest contemporary challenges to the WTO emerge from the ability of its decision-making process to continue to produce outcomes in a changing world. On the one hand, the growth of WTO membership and the emergence of the G-20 as a powerful bloc within the organization has raised the stakes of trade negotiations and made it more difficult to find packages acceptable to the full membership. On the other hand, the emergence of a vocal NGO movement critical of the WTO's apparent tendency to place business interests before consumer interests has made it even more difficult to reach agreements within the organization. The full consequences of these two challenges remain uncertain. Can governments reform decision making in the system in a way that simultaneously enhances its legitimacy and efficiency? Or will continued decision-making paralysis impart additional impetus to regionalism?

KEY TERMS

Customs Union
Dispute Settlement Mechanism
The Doha Round
Free Riding
Free-Trade Area
Generalized System of Preferences
Hegemon
Hegemonic Stability Theory
Intergovernmental Bargaining
Market Liberalism
Mega-Regional Agreements
Ministerial Conference
Most-Favored Nation
National Treatment
Nondiscrimination
Non-tariff Barriers
Public Good
Regional Trade Arrangement (RTA)
Tariffs
Trade Creation
Trade Diversion

World Trade Organization (WTO)

SUGGESTIONS FOR FURTHER READING

A thorough investigation of the WTO and the Doha Round is available in Kent Jones, *Reconstructing the World Trade Organization for the 21st Century: An Institutional Approach* (New York: Oxford University Press, 2015).

The WTO's uncertain future is explored in Judith Goldstein, 2017. "Trading in the Twenty-First Century: Is There a Role for the World Trade Organization?" *Annual Review of Political Science* 20(1): 545–564.

For a more historical treatment, see John H. Barton, Judith L Goldstein, Timothy E Josling, and Richard H Steinberg. *The Evolution of the Trade Regime: Law, Politics, and Economics of the GATT and the WTO* (Princeton: Princeton University Press, 2006).

Finally, a more analytical approach is provided by Bernard Hoekman and Michel M. Kostecki, *The Political Economy of the World Trading System: The WTO and Beyond*, 3rd ed. (New York: Oxford University Press, 2009).

CHAPTER 3

The Political Economy of International Trade Cooperation

The disappointing achievements realized from the Doha Development Round raise serious questions about the WTO's future. The WTO and its predecessor the GATT have been at the center of the international trade system for 70 years. Yet, today, the rise of new issues and the associated emergence of the mega-regionals highlights the willingness of some WTO member governments to pursue their trade policy goals outside the WTO framework. The Trump administration's reliance on aggressive bilateralism and extended review of WTO rules constitutes another challenge to an organization struggling to justify its relevance. Today, perhaps more than at any previous point in time, the centerpiece of the postwar multilateral trade system is under threat. Do the world's governments still need the WTO?

Most analysts would argue, I believe, that the WTO remains an important and perhaps even necessary centerpiece of the global trade system. The claim that governments still need the WTO is typically framed in terms of a somewhat abstract theory of international cooperation. This theory tells us that international cooperation is difficult, even when all states stand to gain from cooperation, because the anarchical international system within which states interact makes it difficult to enforce any agreements that they might make. The challenges associated with enforcing international agreements create opportunities for some states to take advantage of others, and the fear of being exploited by others can make states reluctant to enter cooperative agreements. As a result, cooperation is stymied; states are worse off than they could be. In the specific context of world trade, this logic suggests that countries could gain substantially from cooperation that liberalizes trade. Yet, because

some governments may want to exploit others, by choosing to keep their market closed to imports while exporting to economies that have liberalized, for instance, and all governments want to avoid being exploited in this fashion, governments are unwilling to make agreements that would liberalize trade. Consequently, societies are deprived of the benefits that trade confers.

Societies often solve such cooperation problems by creating common institutions that help them enforce agreements. This is how and why the WTO remains important. The WTO helps states enforce trade agreements and in doing so enables states to capture the mutual benefits that trade provides. The WTO performs this role by providing common rules that provide enforceable standards to which states' trade policies must conform. The WTO helps states collect and disseminate information about the degree to which specific trade policies do in fact conform to these standards. And finally, the WTO enables states to sustain cooperation by helping them adjudicate the disputes that do arise. The WTO remains important, therefore, because it enables societies to cooperate and capture the welfare gains that trade offers.

This chapter develops this logic of international trade cooperation in three essential steps. First, we examine trade theory to gain a firm understanding of why trade offers welfare gains to all countries. This examination is important in its own right, but it also highlights the gains available from international cooperation aimed at liberalizing trade. Second, using a standard model of cooperation, the prisoners' dilemma, we examine why cooperation to capture the welfare gains available from trade is difficult. Third, we examine how the WTO helps governments enforce the agreements they reach.

THE ECONOMIC CASE FOR TRADE

Why should countries trade? The standard answer is that countries should trade because trade makes them better off. Grasping why, exactly, trade makes societies better off, however, can be tricky. As the prominent economist Paul Krugman has argued, even many scholars and journalists who spend their lives writing about the global economy don't fully understand why trade makes societies better off (Krugman 1997, 117–125). Because understanding the rationale for trade is central to understanding the global economy but can be difficult to grasp, we develop the logic of comparative advantage in some detail.

We begin by establishing a few core concepts. The first is the

production possibility frontier (PPF). Countries are endowed with factors of production in finite amounts. Consequently, any decision to use factors to produce one good, necessarily means that these factors are not available to produce other goods. A decision to allocate capital and labor to the production of computers, for example, necessarily requires the country to forgo the production of some number of shirts. These forgone shirts are what economists call opportunity costs, and the production possibility frontier allows us to measure these opportunity costs quite precisely.

Consider an illustrative PPF for the United States. Let's assume that the United States has a fixed stock of labor and capital that it can use in combination to produce two goods—shirts and computers. Suppose that if the United States allocates all its labor and capital to computer production, it could produce 100 million computers (point *A* in Figure 3.1) and if it allocates all labor and capital to shirts, it can produce 300 million shirts (point *B* in Figure 3.1). If we connect *A* and *B* with a line, we have defined a production possibility frontier for the United States. Along it lie all combinations of shirts and computers that the United States can produce using all of its factors of production. As we move from *A* to *B*, capital and labor are reallocated away from computer production to shirt production. The slope of the line, called the marginal rate of transformation, tells us exactly how many shirts the United States forgoes for each computer it produces. In this example, every computer the United States produces costs three shirts. Because an autarkic country cannot consume more than it produces, the PPF also defines the limits of possible consumption.

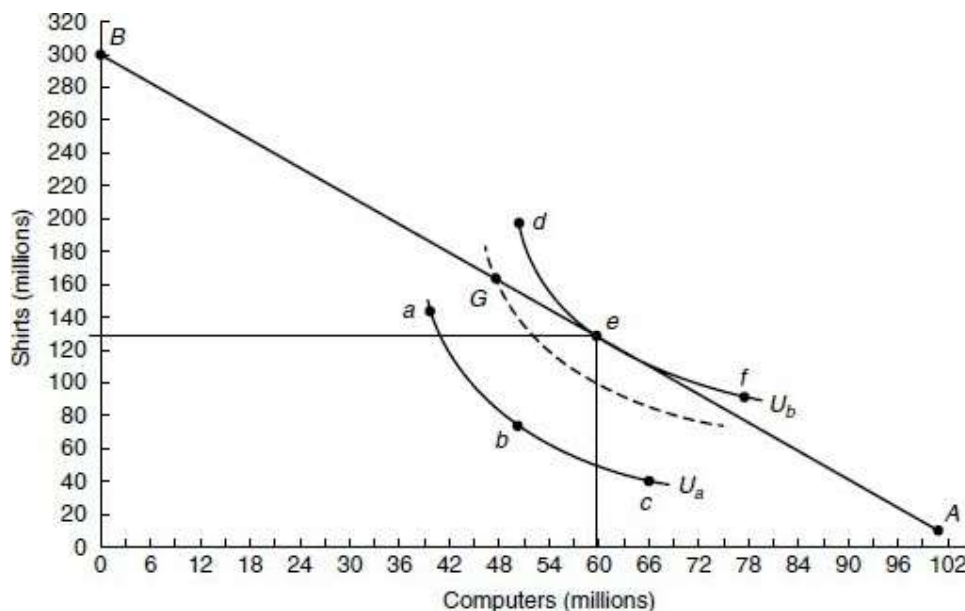


FIGURE 3.1

U.S. Production Possibility Frontier

We can draw the PPF either as a straight line, as in our example, or as a curved line. Which we select depends upon the assumption we make about the nature of the opportunity costs that the United States faces. A straight PPF embodies the assumption that the United States faces constant opportunity costs. Every additional computer always costs three shirts. If we assume constant opportunity costs, we also implicitly assume that the United States enjoys constant returns to scale in production. This means that whenever the factors employed in shirt production are increased by some factor, we will increase the number of shirts produced by the same factor. Double the amount of labor and capital employed in shirt production and double the number of shirts produced. Alternatively, we could assume that the United States faces *increasing* opportunity costs and connect points *A* and *B* with a curved line that bends out away from the origin. The shift from producing 49,999,999 computers to 50 million computers costs three shirts. Yet, when the United States moves from producing 89,999,999 to 90 million computers, it costs seven shirts. Thus, the opportunity cost of producing each good rises as the United States dedicates a larger share of its factors to the production of a single good. If we assume the United States faces increasing opportunity costs, we are also implicitly assuming that factors yield diminishing marginal returns. This means that the number of additional computers the United States can produce for each additional worker employed in computer production will fall as the number of workers employed in computer production rises. Most contemporary models assume that factors yield diminishing marginal returns. To keep things simple, we will assume constant marginal returns.

Our second core concept, consumption indifference curves, helps us understand the specific combination of computers and shirts American consumers will purchase. Consumers will acquire shirts and computers in the combination that maximizes their collective utility. Economists conceptualize consumer utility with indifference curves. We assume that consumers prefer more to less, and therefore consumer utility increases as we move away from the origin. Some combinations of shirts and computers, such as those at points *a*, *b*, and *c* on [Figure 3.1](#), yield the same amount of utility. If asked to choose between these three, our consumer will say, “I like them all the same.” If we connect every combination of shirts and computers that provides our consumer with the same amount of utility with a curved line such as U_a , we have drawn an indifference curve. Our consumer enjoys identical utility from every combination of shirts and

computers that falls on U_a . We can draw a second indifference curve that links the combinations d , e , and f . Each of these combinations yield more utility than a , b , or c , and are thus said to lie on a higher indifference curve. But, our consumer is indifferent between d , e , and f . We can connect these three combinations with a second indifference curve, U_b . Were we to repeat this exercise for every possible combination of shirts and computers within this two-dimensional space, we would have a complete indifference map.

Three additional characteristics of indifference curves are important. First, indifference curves typically slope downwards. This slope, called the marginal rate of substitution, tells us how much of one good the consumer is willing to give up to acquire an additional unit of the second good. Second, indifference curves typically bend in toward the origin. This reflects the assumption of diminishing marginal utility. The first computer provides a large improvement in utility. Each successive computer, however, provides a smaller increase of utility. Consequently, even though the consumer might be willing to give up a large number of shirts to acquire her first computer, she will be willing to give up fewer shirts to acquire her sixth computer. Finally, when we focus on production and consumption for an entire country, we construct community indifference curves rather than individual indifference curves. Community indifference curves aggregate utility for all consumers in that society. In this example, then, our community indifference curves embody the aggregated preferences of all American consumers.

Together, the PPF and indifference curves allow us to define equilibrium production and consumption of shirts and computers in this autarkic American economy. Production and consumption will occur at the point where the marginal rate of transformation (the slope of the PPF) is equal to the marginal rate of substitution (the slope of the indifference curve). That is, production and consumption will occur where the PPF and the indifference curve are tangent. This is point e on [Figure 3.1](#).

Why must production and consumption occur only at this point? Suppose the United States initially produced and consumed at G . Society can gain greater utility than at G (consumers can shift to a higher indifference curve) by consuming fewer shirts and more computers. We would therefore expect consumers to demand fewer shirts and more computers and we would expect production to shift in response, producing more computers and fewer shirts. Beyond e , consuming additional computers and fewer shirts decreases consumer utility. Consequently, consumers will begin to demand more shirts and fewer computers. Only at

e is it impossible to achieve higher utility from a different combination of shirts and computers. Consumer utility is thus maximized by producing and consuming at e . Under autarky, therefore, equilibrium production and consumption in the United States equals 60 million computers and 120 million shirts.

To see how trade changes this equilibrium, we must introduce a country for the United States to trade with. We will assume that the only other country in the world is China. We construct China's PPF just as we did for the United States (see [Figure 3.2](#)). Let's suppose that if China dedicates all its labor and capital to computers, it can produce 20 million computers. If it dedicates all its labor and capital to shirt production, it can produce 400 million shirts. Connecting these two points yields China's PPF. Given our assumptions, China's marginal rate of transformation is 20: every computer China produces carries opportunity costs of 20 shirts. We then find the point of tangency between China's consumer indifference curves and the PPF to identify equilibrium production and consumption in an autarkic China. Based on our assumptions, equilibrium production and consumption in autarkic China yields 13 million computers and 140 million shirts under autarky.

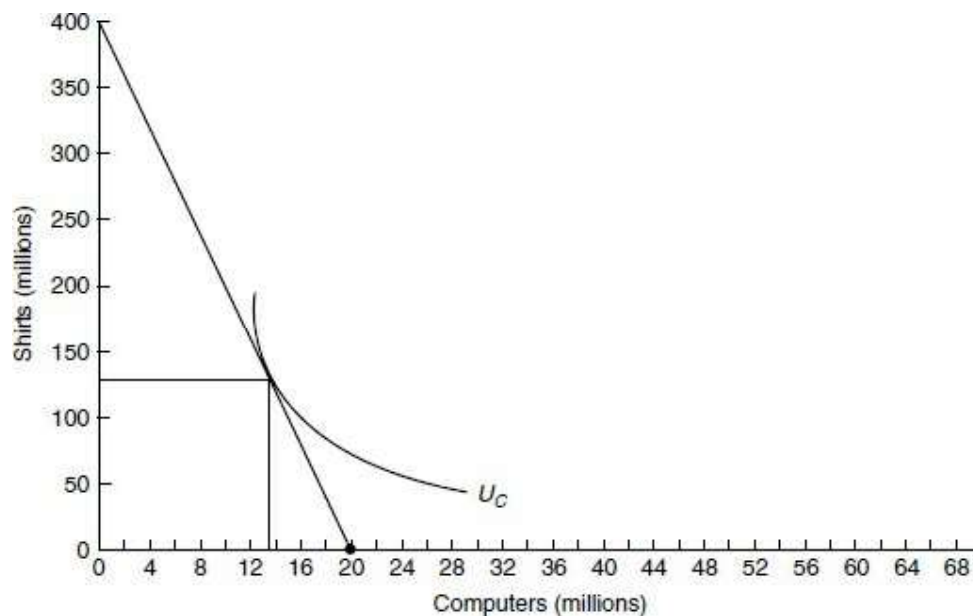


FIGURE 3.2

China's Production Possibility Frontier

We can now see how trade between the United States and China affects equilibrium production and consumption in both countries (see [Figure 3.3](#)). Trade changes equilibrium production by causing each country to

specialize in the production of one good. The United States specializes in computer production and stops producing shirts. China specializes in shirt production and stops producing computers. Specialization arises from the conclusions each draws from a simple price comparison. The United States acquires more shirts per computer when it buys them from China than when it produces them at home. A computer buys 20 shirts in China whereas at home it buys only three shirts. Why should the United States produce shirts at home when it can acquire them for substantially less in China? The United States thus stops producing shirts, produces only computers, and acquires the shirts it wants from China.

Similarly, China acquires more computers per shirt when it buys them from the United States than when it produces them at home. China can acquire a computer from the United States for only three shirts whereas if it produces computers at home each computer costs 20 shirts. Why should China produce computers when it can acquire them much less expensively from the United States? China therefore stops producing computers, specializes in shirts, and acquires the computers it wants through trade with the United States. Trade thus changes equilibrium production in both countries: the United States specializes in computer production and China specializes in shirt production.

To see how trade affects equilibrium consumption in both countries, we need to know the price at which the United States and China will exchange shirts for computers. We know that this price must fall somewhere between three and 20 shirts per computer. We could solve for the exact price that will arise, but we'll simply assume that the two agree to trade at six shirts per computer. This new price is depicted in [Figure 3.3](#) as the dashed line labeled pt . Now we must find the combination of shirts and computers that maximizes consumer welfare in each country at this new price. To do so, we find the point of tangency between the new price line and our consumer indifference curves. These points are labeled C_{US} and C_C , respectively.

Equilibrium consumption in both countries has thus expanded beyond what was possible under autarky. American consumption expands from 60 million computers and 120 million shirts under autarky to 75 million computers and 150 million shirts. Chinese consumption expands from 13 million computers and 140 million shirts under autarky to 25 million computers and 250 million shirts. At this new equilibrium, both countries consume more shirts and computers than they could under autarky. Consequently, consumers achieve greater utility, which is reflected in the

move to higher indifference curves (U'_{US} and U'_C , respectively). This additional consumer utility is the gain from trade. Trade between the United States and China is thus beneficial for both countries.

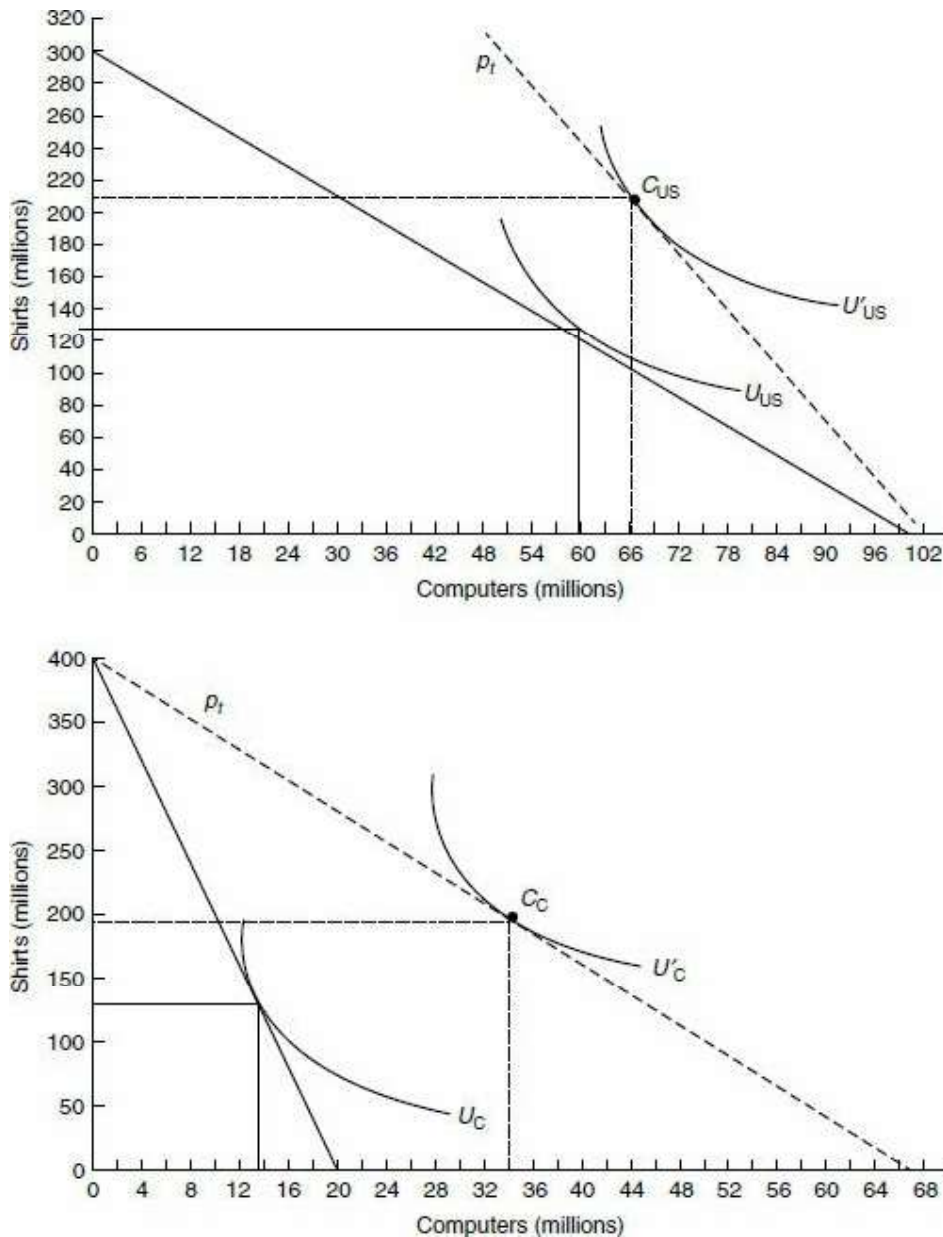


FIGURE 3.3
Equilibrium with Free Trade and Complete Specialization

This specific example illustrates the broader claim that *every* country gains by specializing in goods it produces relatively well and trading them for the goods it produces relatively less well. This is the principle of comparative advantage. These gains are not dependent upon having an

absolute cost advantage in a particular industry. The United States does not gain because it produces computers more cheaply than China. It gains because it can acquire more shirts per computer in China than it can at home. And these gains exist even if shirts cost more to produce in China than in the United States. Thus, even countries that produce every good at a higher cost than all other countries gain from trade by specializing in the goods they produce best. This is the logic of comparative advantage.

What determines which goods a particular country will produce relatively well and which it will produce relatively less well? The **Heckscher-Ohlin** (or H-O) **model**, (named after the two Swedish economists, Eli Hecksher and Bertil Ohlin who developed it) provides the standard answer. The H-O model argues that comparative advantage arises from differences in **factor endowments**. Factors are the basic tools of production. When firms produce goods, they employ labor and capital in order to transform raw materials into finished goods. Labor obviously refers to workers. Capital encompasses the entire physical plant that is used in production, including the buildings that house factories and the machines on the assembly lines inside these factories.

Countries possess these factors of production in different amounts. Some countries, like the United States, have a lot of capital but relatively little labor. Other countries, such as China, have a lot of labor but relatively little capital. These different factor endowments in turn shape the cost of production. A country's abundant factor will be cheaper to employ than its scarce factor. In the United States and other advanced industrialized countries, capital is relatively cheap and labor is relatively expensive. In developing countries, labor is relatively cheap and capital is relatively expensive.

Because countries have different factor endowments and face different factor prices, countries will hold a comparative advantage in different goods. A country will have a comparative advantage in goods produced using a lot of their abundant factor and a comparative disadvantage in goods produced using a lot of their scarce factor. In the auto industry, for example, payments to labor account for between 25 and 30 percent of the total cost of production. The much larger share of the costs of production arise from capital expenditures, that is, expenditures on the machines, assembly lines, and buildings required to build cars (Dicken 1998). In contrast, in the apparel industry, wages paid to workers account for the largest share of production costs, whereas capital expenditures account for a much smaller share of the costs of production. It follows that countries like the United States and Japan with a lot of capital and little labor will

have a comparative advantage in producing cars and a comparative disadvantage in producing clothing. By the same logic, developing countries with a lot of labor and little capital will have a comparative advantage in producing clothing and a comparative disadvantage in producing cars.

Thus, in our example, the United States has a comparative advantage in computers and not in shirts because the United States is abundantly endowed with physical and human capital and poorly endowed with low-skilled labor. China has a comparative advantage in shirts and not in computers because China is abundantly endowed with labor and poorly endowed with human and physical capital. Comparative advantage tells us, therefore, that all countries gain from trade by specializing in the goods that rely heavily on the factors of production that they hold in abundance and exchanging them for goods that make intensive use of the factors of production that are scarce in their economy.

TRADE BARGAINING

Although trade liberalization raises the standard of living, governments don't often liberalize trade unilaterally. Instead, governments strive to open foreign markets to the exports of competitive domestic industries and continue to protect less competitive industries from imports. As a result, trade liberalization generally occurs through trade **bargaining** in which governments exchange market access commitments.

We can model trade bargaining using basic spatial theory. To keep things concrete, we will model the central bargaining problem in the Doha Round. We begin by defining the bargaining space. The two issues at the center of the Doha Round are the reduction of barriers to trade in agriculture products that governments in the advanced industrialized countries impose and the reduction of barriers to trade in manufactured goods (called Non-agricultural Market Access (NAMA) in the Doha Round) that governments in developing countries impose. We can depict each of these as a policy dimension (see [Figure 3.4a](#)). The horizontal axis depicts all possible levels of agriculture protection in the advanced industrialized countries. Protection of agriculture is zero at the origin and barriers to trade rise as we move out toward the right. The vertical axis captures all possible levels of protection of manufactured goods in developing countries. Again, protection is zero at the origin and increases as we move up from the origin. Each point within the two-dimensional bargaining space represents a combination of trade barriers in

industrialized-country agriculture and developing-country manufactured goods.

We can locate the current levels of protection, the status quo, in this bargaining space. The status quo is characterized by a fairly high level of protection in both sectors. The United States, the EU, and Japan excluded agriculture from multilateral trade negotiations until quite recently. Consequently, trade barriers in this sector remain quite high. Similarly, developing-country governments did not participate much in bargaining rounds prior to the Uruguay Round. As a result, they retain high tariffs on manufactured goods. Hence, the status quo, labeled SQ in [Figure 3.4a](#), falls in the northeast quadrant of the bargaining space.

In our next step we locate government ideal points in the bargaining space. An actor's ideal point is its best possible outcome, in this instance the specific combination of barriers to trade in agriculture and manufactured goods that each actor prefers to all other combinations. Rather than depict ideal points for each of the 164 WTO members, we focus on two coalitions at the center of bargaining, the United States/EU and the Group of 20. We locate these ideal points using a simple rule—governments liberalize comparatively advantaged sectors and protect disadvantaged sectors. The United States/EU is relatively poorly endowed with land and relatively abundantly endowed with capital. The ideal outcome from their perspective is a sharp reduction of tariffs on G-20 goods markets and continued protection of their agriculture sector. Their ideal point therefore lies in the southeast quadrant of the bargaining space. Governments in the Group of 20 are abundantly endowed with land and poorly endowed with capital. The ideal outcome for these governments combines low barriers on agricultural markets in the EU and the United States, with high barriers on their goods markets. The ideal point for the Group of 20 thus lies in the northwest quadrant of the bargaining space.

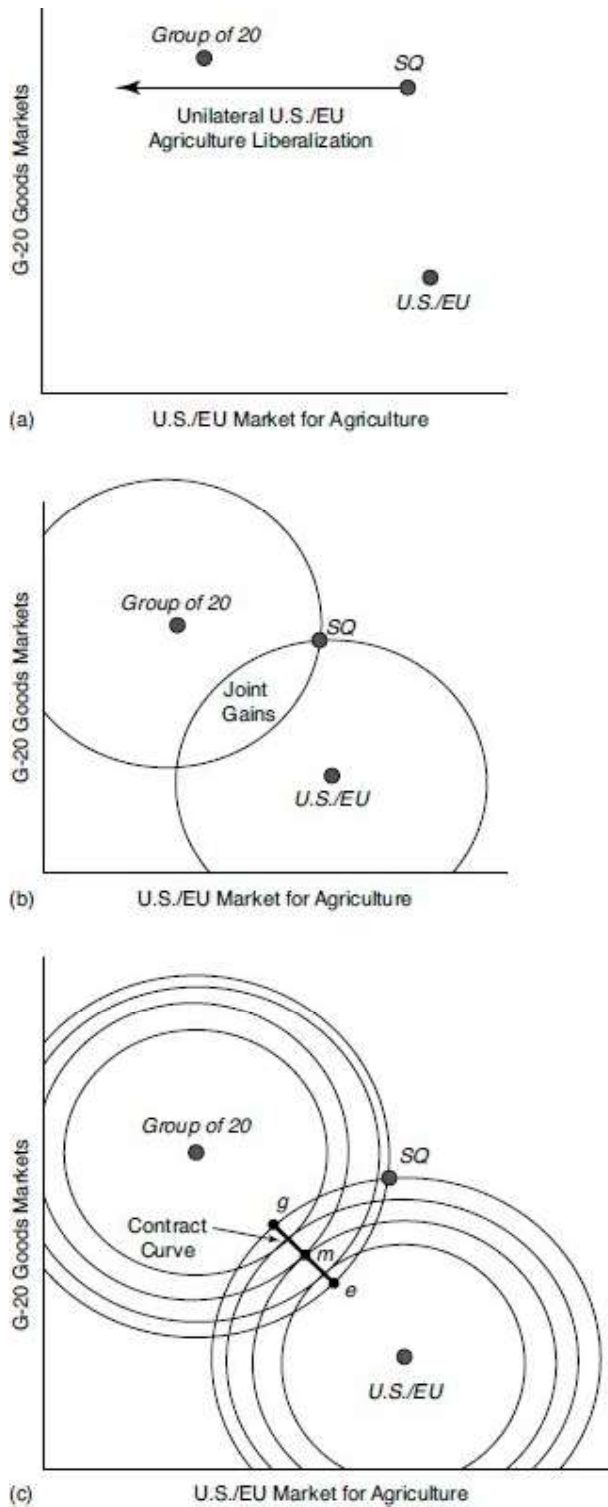


FIGURE 3.4

Tariff Bargaining in the Doha Round

Notice that given these ideal points and the status quo, neither group can improve its utility relative to the status quo from unilateral liberalization.

Assume that utility for each actor is a linear function of distance; that is, utility decreases as we move away from the ideal points in any direction. Unilateral reduction of protectionist barriers on United States/EU agriculture shifts the outcome from SQ toward the left along a line parallel to the horizontal axis. Every point on this line is further from the United States/EU ideal point than SQ and thus offers less utility than the SQ. Similarly, any unilateral reduction of tariffs on manufactured goods shifts the SQ down along a line parallel to the vertical axis (not drawn). Every point on this line is further from the G-20 ideal point than SQ. Hence, neither group can realize higher utility by engaging in unilateral liberalization.

What neither is willing to do unilaterally, both are willing to do through international bargaining. To see why, we must first identify all outcomes that each group prefers to the status quo. We can see these outcomes by drawing circular indifference curves centered upon each group's ideal point, with a radius equal to the distance between this ideal point and the status quo (see [Figure 3.4b](#)). Each group prefers all outcomes interior to this indifference curve to the status quo. The combinations within the "lens" created by the intersection of the two indifference curves are thus outcomes that the G-20 and the United States/EU both prefer to the status quo. And in the vast majority of these outcomes, each group has liberalized the sector it wishes to protect quite substantially. International bargaining, therefore, enables governments to liberalize domestic sectors that they are unwilling to liberalize unilaterally.

The selection of one outcome from all of those that offer joint gains carries distributional consequences. Some agreements benefit the United States/EU more than the G-20, and some agreements benefit the G-20 more than the United States/EU. We can see this by drawing a series of indifference curves for each group (see [Figure 3.4c](#)). We then connect all the points at which the United States/EU and Group of 20 indifference curves are tangent to one another. The result is a **contract curve**—the set of mutually beneficial agreements that exhaust available joint gains. We assume that governments will select an agreement from that set. Now, each agreement on this contract curve carries a different distribution of the joint gains. If the Group of 20 and the United States/EU select the outcome represented by m , they divide available joint gains evenly. If they select an outcome between m and e , the United States/EU realizes larger gains than the Group of 20. If instead they choose an outcome between m and g , the Group of 20 realizes larger gains than the United States/EU. Hence, governments are not just realizing joint gains, they are also deciding how

to distribute these gains between them.

Bargaining power determines which distribution of gains governments ultimately select. Although we often think of power as brute force, bargaining power derives from an array of much subtler characteristics such as patience and outside options. **Patience** refers to the fact that both parties to the negotiation would prefer to settle today rather than tomorrow. Because each side gains from agreement, delaying agreement sacrifices utility for both. But if one government is more patient than another, it can use its willingness to wait to insist on an outcome closer to its ideal point, and thereby capture more of the joint gains for itself. A government may be less patient, and thus willing to concede some of the surplus to other governments in exchange for a quick deal, if it is relatively poor (since economic gains have greater marginal utility for poorer states), or if it has a low tolerance for risking a breakdown in negotiations.

A Closer Look

Bargaining Strategy, Bargaining Power, and the Doha Round

Did the Doha Round fail as a result of a strategic miscalculation on the part of the G-20? Consider the G-20's bargaining strategy as they confronted the U.S. and the EU. The best deal for each government is the one that combines maximum concessions from other members in exchange for minimal concessions. Group of Twenty (G20) governments want large reductions in American and European agricultural protection in exchange for minimal liberalization of their manufacturing and service sectors. American and European governments seek the opposite—maximum G20 cuts in manufacturing and services in exchange for minimal cuts in farm tariffs and subsidies. In bargaining, therefore, governments were tussling over the distribution of the available joint gains, and the agreement best for a G20 government is necessarily less good for the United States and the European Union (EU) (though still better for both than no agreement).

Each government's ability to negotiate the best possible deal for itself is complicated by private information. G20 governments did not know how much American and European governments were willing to reduce farm tariffs and subsidies. Nor did they know how much they had to offer in exchange for such liberalization. Each government held these critical pieces of information about its negotiating position

privately, and had no incentive to reveal them to others. If American negotiators told the G20 the maximum cuts in farm tariffs and subsidies the United States would make, then G20 governments would accept nothing less than this maximum. If the United States told the G20 governments the minimal amount of service and NAMA liberalization it expected in return, G20 governments would offer only this minimal amount. Revealing private information about their negotiating positions thus condemns governments to their worst possible deal—minimal gains and maximal concessions.

Negotiating the best deal possible thus requires governments to force each other to reveal information they do not wish to reveal. This is exactly the situation governments faced in Geneva in July 2008. Trade ministers had negotiated for 9 days. By Tuesday, they had reached the point at which each government had to decide whether the resulting package was the best deal it could get. China and India had to decide whether the United States and the EU had made their maximum concessions. Yet, they knew that asking for additional concessions was pointless—they had been asking for 9 days, and asking for more now would simply elicit a quick “No, this is my best offer.” China and India could learn if, in fact, the offer on the table was the best offer only by walking away from the negotiations.

Walking away from the table constituted a strategic gambit. Walking out delivered a “costly signal”: it transformed cheap talk (we want additional concessions) into costly action (we’ll forgo this agreement now to get additional concessions in the future). This costly action, which demonstrated that India and China were patient, could have made American policymakers more likely to believe that additional concessions would be necessary to get a deal. Walking away could have also imposed costs on the United States by denying it an agreement it wanted. By walking out of negotiations, therefore, India and China were trying to gain information about the U.S. bargaining position. If the United States offered additional concessions, India and China would get a better deal and their gamble would have paid off. But even if the United States failed to offer additional concessions, China and India would still gain valuable information that the United States had offered all that it would offer. They could then accept the deal on the table.

This strategic gambit failed, however, because India and its allies neglected to take into full account the outside options available to the U.S. and the EU. A walk-out strategy can work only if one’s

bargaining partner has no opportunity to achieve its objectives by making deals with other partners. In the absence of outside options, the U.S. and EU would be compelled to reach agreement with the G-20 in the WTO. As it turned out, however, the WTO wasn't the only game in town. After 2008, the U.S. began to pursue its trade policy objectives through mega-regional trade agreements with the EU and in Asia and the Pacific. EU policymakers also began pursuing trade agreements outside of the WTO framework. Moreover, as these mega-regional negotiations progressed it became clear that the U.S. and the EU could realize more of their trade policy goals and make fewer major concessions through the mega-regional framework than by continuing to work within the larger WTO. Consequently, American policymakers came to place greater value upon the outside option and less value on the Doha Round. This made it less and less likely that they would offer major concessions to the G-20.

Of course, I don't know whether the G-20's decision to walk out was a strategic gambit or whether it reflected a sincere preference that the deal on the table didn't offer benefits. Yet, it is interesting to consider the possibility that the Doha Round could have concluded quite differently had key players made different strategic calculations.

If governments are equally patient, one government may gain bargaining power if it has an attractive outside option. An **outside option** is a government's next-best alternative to agreement. For example, if the EU can strike a similar bargain with the United States, then it has little need to make large concessions to the Group of 20: it can leverage its potential deal with the United States to extract concessions from the Groups of 20. If the Group of 20 knows this, it will be willing to allow the EU to capture a larger share of the gains than it would if the outside option of a deal with the United States did not exist. Somewhat paradoxically, therefore, giving one side a good reason to *not* reach agreement often enables governments to find common ground. The U.S. strategy of negotiating regional trade agreements, for example, might be an attempt to demonstrate an outside option in order to gain greater power within WTO negotiations.

In short, governments liberalize trade via trade agreements because they are unwilling to liberalize unilaterally. Given their focus on export expansion, trade negotiations enable governments to exchange market access commitments. Although the resulting trade agreements yield

benefits to all parties, they also carry distributional consequences. Some governments will realize smaller gains in market access opportunities in exchange for larger concessions of their own. These distributional consequences reflect differences in bargaining power. Governments that are most willing to wait, that are willing to risk a breakdown of negotiations, and that have outside options are likely to capture a larger share of the available gains from agreement.

ENFORCING AGREEMENTS

The ability of governments to conclude trade agreements is additionally frustrated by the second intervention of politics: the enforcement problem. The **enforcement problem** refers to the fact that governments cannot be certain that other governments will comply with the trade agreements that they conclude (Conybeare 1984; Keohane 1984; Oye 1986). As a result, governments will be reluctant to enter into trade agreements, even when they recognize that they would benefit from doing so. Even though this might seem counterintuitive, we can use a simple game theory model, called the prisoner's dilemma, to see how the enforcement problem can frustrate the efforts of governments to conclude mutually beneficial trade agreements.

Suppose that the Group of 20 and the EU manage to identify an outcome that each prefer to the status quo. In the absence of a mechanism to enforce the agreement, would they be able to conclude the agreement? The prisoner's dilemma tells us that they will be unable to do so. In the prisoner's dilemma, the Group of 20 and the EU each have two strategy choices: each can open its market to the other's exports, which we will call *liberalize*, or each can use tariffs to keep the other's products out of its domestic market, which we will call *protect*. Two governments with two strategy choices each generates the two-by-two matrix depicted in [Figure 3.5](#).

		European Union	
		Liberalize	Protect
G-20	Liberalize	L,L <i>I</i>	L,P <i>II</i>
	Protect	P,L <i>IV</i>	P,P <i>III</i>

Preference Orders:
 G-20: $P,L > L,L > P,P > L,P$
 European Union: $L,P > L,L > P,P > P,L$

FIGURE 3.5

The Prisoner's Dilemma and Trade Liberalization

Each cell in this matrix corresponds to a strategy combination, and these strategy combinations produce outcomes. We can describe these outcomes starting in the top left cell and moving clockwise. One word about the notation we use before we proceed. It is conventional to list the strategy choice of the row player (the player who selects its strategy from the rows of the matrix) first and the strategy choice of the column player (the player who selects its strategy from the columns of the matrix) second. Thus, the strategy combination referred to as “*liberalize/protect*” means that the row player, which in this case is Group of 20, has played the strategy *liberalize* and the column player, which is the EU, has played the strategy *protect*.

We can now describe the four outcomes.

- *Liberalize/Liberalize*: Both eliminate tariffs. Group of 20 exports agricultural products to the EU, and the EU exports manufactured goods to Group of 20 countries.
- *Liberalize/Protect*: The Group of 20 eliminates tariffs, but the EU does not. The EU thus exports goods to the Group of 20, but the Group of 20 cannot export farm goods to the EU.
- *Protect/Protect*: Both retain their tariffs. No trade takes place.
- *Protect/Liberalize*: The EU eliminates tariffs, and the Group of 20 does not. The Group of 20 exports farm goods to the EU, but the EU cannot export manufactured goods to the Group of 20.

Now we must determine how each government ranks these four outcomes. How much utility do they realize from each outcome? The Group of 20 ranks them in the following order:

protect/liberalize > liberalize/liberalize > protect/protect > liberalize/protect

where the “greater than” sign means “is preferred to.” It is not hard to justify this ranking.

- The Group of 20 gains the most utility from *protect/liberalize*. Here the Group of 20 exports to the EU and protects its producers from EU competition.
- The Group of 20 gains less utility from *liberalize/liberalize* than from *protect/liberalize*. Here the Group of 20 can export to the EU, but must open its market to EU imports.
- The Group of 20 gains still less utility from *protect/protect* than from *liberalize/liberalize*. Here the Group of 20 protects its domestic market, but cannot export to the EU.
- The Group of 20 gains less utility from *liberalize/protect* than from *protect/protect*. Here the Group of 20 opens its market to the EU but does not get access to the EU market.

In other words, the Group of 20’s most preferred outcome is unreciprocated access to the EU market. Its second-best outcome is reciprocal tariff reductions, which is in turn better than reciprocal protection. The Group of 20’s worst outcome is a unilateral tariff reduction.

The prisoner’s dilemma is a symmetric game. This means that the EU faces the exact same situation as the Group of 20. Consequently, the EU’s payoff order is identical to the Group of 20’s payoff order. The only difference arises from the notation we use. Like the Group of 20, the EU’s most preferred outcome is unreciprocated access to the other’s market, but for the EU this is the outcome *liberalize/protect*. Also like the Group of 20, the EU’s least preferred outcome is granting the other unreciprocated access to its market, which for the EU is the outcome *protect/liberalize*. Thus, the EU’s payoff order is identical to the Group of 20’s payoff order, but the position of the most and least preferred outcomes are reversed:

liberalize/protect > liberalize/liberalize > protect/protect > protect/liberalize

We can now see how the Group of 20 and the EU will play this game and what outcome will result. The Group of 20 and the EU both have a dominant strategy—a single strategy that always returns a higher payoff than all other strategy choices. *Protect* is this dominant strategy. *Protect* dominates *liberalize* as a strategy choice because each government will

always realize higher utility by playing *protect* than by playing *liberalize*.

We can see why *protect* is a dominant strategy by working through the Group of 20's best responses to the EU's strategy choices. Suppose the EU plays the strategy *liberalize*. If the Group of 20 plays *liberalize* in response, the Group of 20 receives its second most preferred outcome (*liberalize/liberalize*). If the Group of 20 plays *protect* in response, the Group of 20 receives its most preferred outcome (*protect/liberalize*). Thus, if the EU plays *liberalize*, the Group of 20's best response—the strategy that returns the highest utility—is *protect*.

Now suppose the EU plays *protect*. If the Group of 20 responds with *liberalize*, it receives its least preferred outcome (*liberalize/protect*). If the Group of 20 responds with *protect*, however, it receives its second least preferred outcome (*protect/protect*). Thus, if the EU plays *protect*, the Group of 20's best response is to play *protect*.

Protect, therefore, “dominates” *liberalize* as a strategy choice—that is, *protect* yields more utility for the Group of 20 than *liberalize* regardless of the strategy that the EU plays. Because the prisoner's dilemma is symmetric, *protect* is also the EU's dominant strategy. Because both governments have dominant strategies to play *protect*, the game always yields the same outcome: the Group of 20 and the EU both play *protect* and the game ends at the *protect/protect* outcome. Governments in both groups retain tariffs and no trade occurs.

This outcome has two important characteristics. First, it is **Pareto suboptimal**. Pareto optimality is a way to conceptualize social welfare. An outcome is Pareto optimal when no single actor can be made better off without at the same time making another actor worse off. Pareto suboptimal refers to outcomes in which it is possible for at least one actor to improve its position without any other actor being made worse off. In the prisoner's dilemma the *protect/protect* outcome is Pareto suboptimal because both governments realize higher payoffs at *liberalize/liberalize* than at *protect/protect*. Thus, rational behavior on the part of each individual government, each playing its dominant strategy *protect*, produces a suboptimal collective outcome. The Group of 20 and the EU are both poorer than they would be if they liberalized trade.

Second, the *protect/protect* outcome is a **Nash equilibrium**. A Nash equilibrium is an outcome at which neither player has an incentive to change strategies unilaterally. If the Group of 20 changes its strategy from *protect* to *liberalize*, the outcome shifts to *liberalize/protect*, the Group of 20's least preferred outcome. Thus, the Group of 20 has no incentive to change its strategy unilaterally. If the EU changes its strategy from *protect*

to *liberalize*, the outcome moves to *protect/liberalize*, the EU's least preferred outcome. Thus, the EU has no incentive to change its strategy unilaterally either. Putting these two points together reveals the prisoner's dilemma's central conclusion: even though the Group of 20 and the EU would both gain from reciprocal tariff reductions, neither has an incentive to reduce tariffs. More broadly, the prisoner's dilemma suggests that even when all countries would clearly benefit from trade liberalization, political dynamics trap governments in a protectionist world.

Governments are unable to conclude agreements that make them all better off because each fears getting the "sucker payoff." If the Group of 20 and the EU agree to liberalize trade and then the Group of 20 complies with this agreement but the EU does not, the EU has exploited the Group of 20. The Group of 20 suffers the "costs" of rising imports without getting the "benefit" of increased exports. The gains from trade liberalization could be achieved, of course, if governments could enforce international trade agreements. Governments could agree in advance *to play* strategies if they were confident that cheating would be caught and punished. Moreover, because cheating would be punished, both would comply with the agreement. The international system provides no enforcement mechanism, however. Domestic political systems rely upon the police and the judicial system to enforce laws, but the international system does not have an authoritative and effective judicial system. Instead, the international system is anarchic; that is, it is a political system without an overarching political authority capable of enforcing the rules of the game.

Although the prisoner's dilemma is pessimistic about the prospect for international trade cooperation, cooperation in a prisoner's dilemma is not impossible. Cooperation can emerge if three specific conditions are met. First, cooperation can emerge in an iterated prisoner's dilemma, that is, in a game played repeatedly by the same governments (see Taylor 1976; Axelrod 1984; Keohane 1984; Oye 1986). Iteration changes the nature of the reward structure that governments face. In a one-shot play of the prisoner's dilemma, countries make a one-time choice and receive a one-time payoff. In an iterated game, however, governments make repeated choices and receive a stream of payoffs over time. Assuming that the two other necessary conditions are met, governments will prefer the stream of payments they receive from cooperating over time to the payoff they receive from cheating on an agreement. Iterating the game can therefore make it rational for a government to play the *liberalize* strategy.

Second, governments must use reciprocity strategies to enforce the *liberalize/liberalize* outcome. Although many **reciprocity** strategies exist,

the most well known is called **tit-for-tat** (Axelrod 1984). In tit-for-tat, each government plays the strategy that its partner played in the previous round of the game. Trade liberalization by one government in one round of play is met by trade liberalization from the other government in the next round. Should one government play *protect* in one round (that is, cheat on an existing trade agreement), the other government must play *protect* in the next round of play. Playing such tit-for-tat strategies allows governments to reward each other for cooperation and punish each other for cheating.

Finally, governments must care about the payoffs they will receive in future rounds of the game. If governments fully discount future payoffs, the iterated game essentially reverts back to a single play of the prisoner's dilemma; when it does, the threat of punishment in the next round of play can hardly be expected to promote cooperation in the current round. But if governments care about the future and if they use a reciprocity strategy such as tit-for-tat, then cooperation in an iterated prisoner's dilemma becomes rational: each government can realize a larger stream of payoffs by cooperating than it can realize by defecting.

The WTO provides the first two of these three necessary conditions. It helps iterate the game by creating expectations of repeated interaction. Membership in the WTO has been relatively stable. The number of countries that belong to the WTO has increased over time, and very few countries have left the organization after joining. As a consequence, WTO members know that the governments with which they negotiate today will be the governments with which they negotiate tomorrow, next year, and on into the future. In addition, WTO members interact regularly within the organization. Governments have already concluded eight formal bargaining rounds and are now engaged in the ninth such round. In addition to these formal rounds of negotiations, the WTO draws governments together for annual and semi-annual reviews of national trade policies. By bringing the same set of governments together in a regularized pattern of interaction, the WTO iterates intergovernmental trade interactions.

The WTO also provides the information that governments need in order to use reciprocity strategies. In order to use a tit-for-tat strategy effectively, governments must know when their partners are complying with trade agreements and when they are cheating. The WTO makes this easier by collecting and disseminating information on its members' trade policies. Moreover, WTO rules provide clear standards against which governments' trade policies can be evaluated. The WTO's most-favored nation clause,

for example, prohibits discriminatory practices except under a set of well-defined exceptions. To give another example, the WTO's rules governing domestic safeguards define the conditions that must be met in order for governments to temporarily opt out of commitments. These detailed rules increase transparency. Transparency means that it is easier for governments to determine whether a specific trade measure adopted by a particular government is or is not consistent with WTO rules. The high-quality information and the transparency provided by the WTO allow governments to monitor the behavior of other WTO members. This in turn makes it easier for governments to use reciprocity strategies to enforce trade agreements.

The ability of governments to use the WTO to enforce trade agreements is most clearly evident in the WTO's **dispute settlement mechanism**. The dispute settlement mechanism follows a standard procedure that was agreed to by all members of the WTO during the Uruguay Round (see [Figure 3.6](#)). A dispute is initiated when a government brings an alleged violation of WTO rules to the WTO Dispute Settlement Body (DSB, consisting of all WTO members). The DSB initially encourages the governments involved in the dispute to try to resolve the conflict through direct consultations. If such consultations are unsuccessful, the DSB creates a formal panel to investigate the complaint.

This panel is typically composed of three experts in trade law who are selected by the DSB in consultation with the governments involved in the dispute. The panel reviews the evidence in the case, meets with the parties to the dispute and outside experts if necessary, and prepares a final report that it submits to the DSB. The DSB must accept the panel's final report unless all WTO members, including the government that initially brought the complaint, vote against its adoption.

Both governments can appeal the panel's decision. If an appeal is requested, the DSB creates an appellate body composed of three to five people drawn from a list of seven permanent members. The appellate body can uphold, reverse, or modify the panel's findings, conclusions, and recommendations. The appellate report is given to the DSB for approval, and as with the panel report, the DSB can reject the report only with the consent of all member governments. If at the end of this process it is determined that the disputed trade measure is inconsistent with WTO rules, the government must alter its policy to conform to the rule in question or compensate the injured parties. The entire dispute settlement process, from initiation to appellate report, is supposed to take no longer than 15 months.

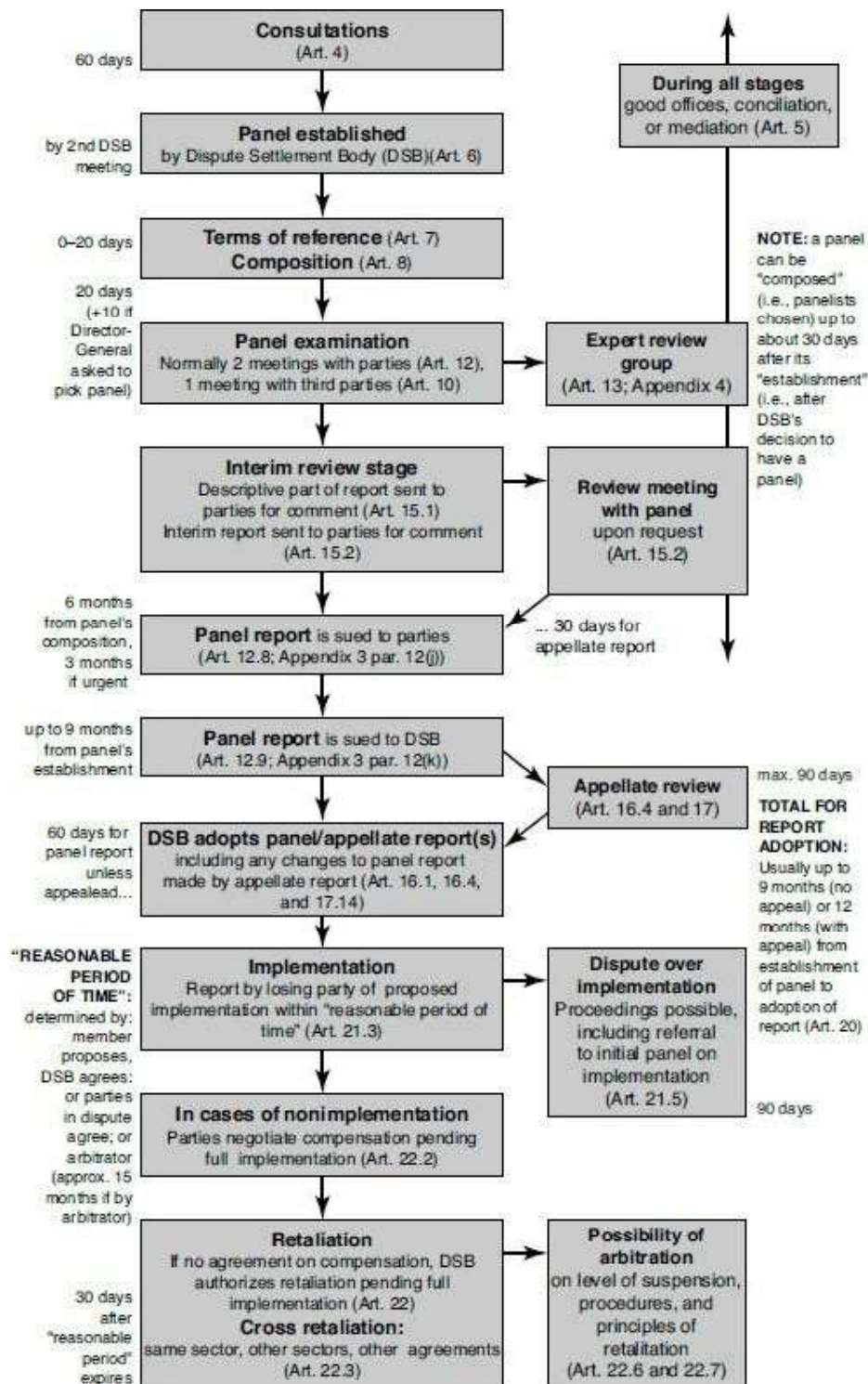


FIGURE 3.6

The Dispute Settlement Mechanism

An ongoing dispute involving American cotton subsidies illustrates how governments use the dispute-settlement mechanism to enforce compliance

with trade agreements (see Schnepf 2010). The cotton subsidy case began in 2002. The Brazilian government complained to the WTO that subsidies paid by the U.S. government to American cotton farmers provided an advantage in global markets that harmed Brazil's cotton growers and violated WTO rules. The Bush administration defended the measures on the grounds that the subsidies represented a "safety net" that protected American cotton growers from volatile global commodity markets. Because the two governments could not settle the dispute through initial discussions, the WTO established a panel in early 2003.

The panel found that American subsidies violated several WTO rules. In particular, the panel ruled that the American cotton policy constituted an export subsidy and domestic production support that harmed Brazilian cotton growers. Although the United States appealed the ruling, the appellate panel upheld it. As a result, the United States modified its policy in an attempt to bring it in line with its WTO obligations. These changes failed to satisfy the Brazilian government, however. They requested that a WTO compliance panel evaluate whether the American adjustment brought the subsidies' regime in line with WTO rules. The compliance panel sided with Brazil; it found that the U.S. policy change was insufficient, a finding upheld by the appellate panel. As a consequence, the WTO authorized Brazil to retaliate against the United States by imposing tariffs on imports of U.S. goods into Brazil up to as much as \$823 million per year, the amount the American cotton policy cost Brazil.

Brazil's threatened imposition of these retaliatory tariffs induced the U.S. government to negotiate a less costly solution to the dispute. In April 2010 the two governments announced the results of these negotiations. Arguing that cotton subsidies formed part of its larger agricultural policy, the United States agreed to reform its cotton subsidies regime only as part of the 2012 Farm Bill. Second, until the subsidies regime is reformed, the United States agreed to pay Brazil \$147 million per year for capacity-building and technical improvement in Brazilian agribusiness. In exchange, Brazil agreed to not impose retaliatory tariffs against U.S. goods, services, or intellectual property. In other words, Brazil accepted current American policy, even though it violated WTO rules, and the United States agreed to compensate Brazil for doing so.

The dispute finally ended in 2014 as a result of two developments. The most important was that the U.S. government restructured its cotton support in the 2014 Farm Bill. Congress removed price supports and direct income supports for cotton producers. In their place, Congress enacted an insurance program that growers must pay into in order to qualify for

payments. Moreover, the insurance fund compensated farmers when they suffered a loss rather than providing benefits to ensure a given income. These changes brought U.S. policy into conformity with WTO rules. Second, once the 2014 Farm Bill was in place, Brazil offered to negotiate a final agreement that would end the dispute. In this agreement, announced on October 1, 2014, Brazil agreed to drop the cotton dispute and refrain from initiating any new WTO actions in return for U.S. commitment to the terms of the Farm Bill and a one-time payment to the Brazil Cotton Institute of \$300 million.

The cotton case illustrates how governments can use tit-for-tat strategies to enforce trade agreements. An alleged defection by the United States prompted a WTO investigation. This investigation indicated that U.S. policy violated WTO rules, and when the United States failed to bring its policies into line with its obligations, Brazil was allowed to retaliate by withdrawing concessions it had made previously to the Americans. In the language of the iterated prisoner's dilemma, the United States defected and Brazil, playing a tit-for-tat strategy, defected in response. Moreover, Brazilian retaliation came only after the WTO had determined that it was justified and the scale of the retaliation was proportionate to the injury suffered. Although the WTO's dispute resolution mechanism focuses our attention on a legalistic version of tit-for-tat, it also allows us to see in a very detailed way how the WTO can promote trade cooperation by helping governments enforce trade agreements. The cotton dispute is especially interesting as an illustration of how even (arguably) the most powerful WTO member can be made to bring its policies into accordance with its WTO obligations.

The WTO thus helps governments gain the assurances they need in order to conclude the trade agreements required to capture the gains from trade. The WTO provides this assurance by allowing governments to monitor the behavior of their trade partners and to enforce the trade agreements they reach. By doing so, the WTO enables societies to capture the welfare gains the trade provides. In the absence of the WTO, or an institution that performed similar functions, it is unlikely that governments would be able to reach the agreements required to liberalize trade. Each society, and thus the world as a whole, would be poorer as a result.

CONCLUSION

The WTO exists, therefore, because it facilitates international cooperation, thereby enabling societies to capture the welfare gains available from

trade. Trade raises social welfare by enabling consumers to enjoy a higher level of utility than if they could consume only goods produced at home. The principle of comparative advantage tells us that these welfare gains do not require a country to have an absolute advantage in anything. As long as a country is better at doing some things than others, it gains by specializing in what it does relatively well and trading for everything else.

Politics, however, makes it difficult for societies to realize these gains from trade. For reasons we examine in greater detail in the next chapter, governments often neglect consumer interests in favor of producer interests. Consequently, governments can capture the gains from trade only by negotiating agreements in which they exchange market access commitments. In such bargaining, governments strive to gain access to foreign markets for their comparatively advantaged industries in exchange for granting access to their markets in their comparatively disadvantaged industries. Consequently, governments employ bargaining power in an attempt to gain maximum access in exchange for minimal concessions. By providing a forum for bargaining, the WTO enables governments to liberalize trade more than they would be willing to do unilaterally.

Yet, concluding trade agreements is also complicated by the enforcement problem. Governments must believe that cooperation on their part will be reciprocated by cooperation from their partners. They must believe that their partners will not try to take advantage of them. And as the prisoner's dilemma highlights, unless such assurances are provided, governments have little incentive to cooperate. The international trade system lacks the equivalent of a state to enforce agreements, and thus governments face a pervasive enforcement problem when they try to cooperate for mutual gain. Consequently, it is difficult for governments to conclude mutually beneficial agreements, and as a result, societies have lower standards of living.

The WTO helps governments solve this enforcement problem. By enabling governments to feel reasonably secure that their partners will comply with the agreements they enter, the WTO provides the assurances necessary to achieve cooperation. Strictly speaking, the WTO is not an international equivalent of a state because the WTO does not have the authority or the capacity to punish governments that fail to comply with trade agreements. Instead, the WTO facilitates international cooperation by providing an infrastructure that allows governments to enforce agreements themselves. By providing a set of mutually agreed rules, by helping governments monitor the extent to which their partners comply with these rules, and by providing a dispute-settlement mechanism that helps

governments resolve those issues of compliance that do arise, the WTO enables governments to enforce effectively the trade agreements that they reach. The WTO thus provides enough assurance that all governments will live up to the agreements that they enter into and that no government will be able to take advantage of the others. By providing this infrastructure, the WTO enables governments to conclude the trade agreements necessary to capture the welfare gains from trade.

KEY TERMS

Bargaining
Contract Curve
Dispute Settlement Mechanism
Enforcement Problem
Factor Endowments
Heckscher-Ohlin Model
Nash Equilibrium
Outside Option
Pareto Suboptimal
Patience
Reciprocity
Tit-For-Tat

SUGGESTIONS FOR FURTHER READING

- For an approach that emphasizes the intuition of the theory of comparative advantage and downplays explicit theory, see Russell D. Roberts, *The Choice: A Fable of Free Trade and Protectionism*, 3rd edition (New York: Pearson, 2006).
- For an excellent account of the theoretical debate over free trade, see Douglas A. Irwin, *Free Trade Under Fire*, 3rd edition (Princeton: Princeton University Press, 2015).
- For comprehensive treatment of the WTO dispute settlement system, you should refer to The World Trade Organization, *A Handbook on the WTO Dispute Settlement System*, 2nd edition (Cambridge: Cambridge University Press, 2017).
- For an evaluation of the dispute settlement mechanism's effectiveness, see Chad P. Bown and Petros C. Mavroidis, 2017. "WTO Dispute Settlement in 2015: Going Strong after Two Decades." *World Trade Review* 16(2): 153–158.