International Economic Studies
Vol. 34, No. 1 (New Issue), Spring & Summer 2009
pp. 1-6
Received: 20-02-2008 Accepted: 12-07-2009

How the WTO Could Be Improved

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Abstract

This paper examines the impasse in the current Doha Development Round negotiations and asks how the rules of the WTO could be changed to facilitate multilateral negotiations and to increase the welfare of the Member countries. It considers possible changes to the method of negotiation. As examples of rules which are outdated, it considers the rules relating to regional trade agreements and to anti-dumping actions. Economic theory suggests strongly that changes to these rules could increase international trade and benefit member countries.

Then to the rolling Heav'n itself I cried, Asking, "What lamp had destiny to guide Her little Children stumbling in the Dark?"

And – "A blind understanding!" Heav'n replied.

The Rubaiyat of Omar Khayyam by Omar Khayyam, translated by Edward Fitzgerald, First Edition, Quatrain XXXIII

Keywords: Reciprocity, Regional Trade Agreements, Anti-dumping Rules, Gains from trade

JEL Classification: F13

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1. Introduction

It is more than eight years since the signing of the Doha Declaration which marked the beginning of the current round of negotiations in the WTO, the so-called Doha Development Round. Attempts to complete the negotiations at the Cancun Ministerial Meeting in September 2003 and again in July 2008 and in December 2008 all failed. The WTO is now in crisis as a result of the stalled negotiations. This makes it timely to review the operation of the WTO.

This paper looks at the method of operation of the WTO as a multilateral organisation and some of its rules. The viewpoint is that of an international economist. It identifies several features of the operation of the WTO which conflict with the recommendations of economic theory. Section 1 examines the notion of reciprocity which is central to the negotiations. The later Sections look at two aspects of the rules of the WTO which are based on outdated and unsound economic ideas – regional trading agreements and anti-dumping rules.

2. A Time for Reflection on Negotiating Rules:

The breakdown of the Current Doha Development round of multilateral negotiations has raised doubts about the methods of negotiations in the WTO and prompted a number of writers to rethink the multilateral trade system. In particular, the Warwick Commission (2007) suggested we need a reflection exercise to rethink the method of operation of the WTO. This paper is undertaken in that spirit.

The scope of issues being considered by negotiations in the current Doha Development Round is broader than those considered in the Uruguay Round and the other rounds carried out by the GATT, as it covers trade in services, trade-related intellectual property laws and other additions to GATT law made in the Uruguay Round. And the number of countries has increased to more than 150. These features have made negotiations much more difficult than in the time of the GATT. We can add to this the concerns over improved[1] access for the Developing Countries in the Doha Declaration and, stemming from that, the new aspirations of these countries.

The core of the problem, however, in my opinion, lies with the approach as much as with the complexities of the issues. After the July failure, in a keynote address to the 2008 WTO Public Forum the Director-General outlined the negotiation problem in the following terms:

"Three principal constraints today represent a challenge to our work: the first is the bottom-up approach, under which members must themselves always take the lead in tabling negotiating proposals and compromise solutions; the second is the concept of a "single undertaking", which implies that in a round of negotiations with 20 different topics, nothing is agreed until all is agreed; and the third is the decision-taking by consensus, which is reasonably close to unanimity." (Lamy, 2008).

Paragraph 47 of the Doha Ministerial Declaration declares that the outcome of these negotiations shall be treated as parts of a single undertaking; the only exception is the improvements and clarifications of the Dispute Settlement Understanding. Thus the outcome is to be treated as a package. In the words of the WTO itself "nothing is agreed until everything is agreed". The last two features mentioned above give a veto to those members who do not agree with a result in any area. These three features operating together have made negotiations very difficult in many areas.

These comments have certainly identified very real problems. A number of writers (see, for example, the views presented at the WTO Public Forum, 2008) have suggested dropping the single undertaking. But there is another fundamental problem, the operation of reciprocity in the GATT/WTO system.

The modus operandi of the WTO negotiations is laid down in Article XXIVIIIbis of GATT 1947. GATT 1994 is the body of law of the GATT that was embedded in the WTO at the time of its creation in 1994. This article calls for

"… negotiations on a reciprocal and mutually advantageous basis, directed to the substantial reduction of the general level of tariffs and other charges on exports and imports and in particular to the

[1]- This is a revised version of a paper presented to Conference on The Future of the Multilateral Trade System at the University of Melbourne, 7 April 2008.

reduction of such high tariffs as discourage even the importation of minimum quantities…"

Article III of the Marrakesh Agreement establishing the WTO stated merely that the WTO shall be a forum for multilateral trade negotiations among its Members. Each member is expected to make offers of reductions in its border barriers to trade in anticipation of receiving some gain form the offers of other members. These offers are referred to, in negotiation parlance, as "concessions".

Paul Krugman (1991) has captured this view brilliantly in the observation that "To make sense of international trade negotiations, one needs to remember three simple rules about the objectives of negotiating countries:

1. Exports are good
2. Imports are bad
3. Other things being equal an increase in imports and exports is good.

In other words, GATT-think is enlightened mercantilism."

The root of the negotiation problems lie with this view of "concessions". This is not just a matter of terminology. Negotiations are carried out by Ministers of the Governments of the Member countries. These Ministers act as if , and I think one has to say they generally believe, the offers made by the respective countries truly impose costs on the economies of the offering nations.

Nothing could be further from the truth. Economic theory shows us that trade is mutually beneficial. This is the Principle of Comparative Advantage that underlies all trade. And the more free the trade, the greater are the mutual benefits. Simulations of the effects of possible trade negotiations done by the World Bank in the Uruguay Round and in the Doha Round have shown time and time again that when a country cuts a tariff rate or eliminates a non-tariff measure, the main beneficiary is not the countries whose access to the markets of this country have been improved but the conceding country itself.

This more modern view is rooted in the results of economic theory that have emerged since the creation of the GATT. We now know that, for a small (price-taking) country, the optimal policy is one of completely free trade. Moreover, if the trade of a small country is partly restricted by barriers to import and export trade which it has imposed itself, the country benefits from systematic reductions in these barriers; for example, by reducing the highest barriers, or across-the-board reductions in all rates of distortions. Modern textbooks include these propositions. It needs to be noted that the gains are gains in terms of aggregate real income. Reducing barriers does not make every household better off. There are losers. If losers are not compensated, they will oppose trade liberalisation.

There is one limited exception to this statement of the gains from trade liberalisation. This is the Large Country or Optimal Tariff argument for tariffs. Consider a country which is large in the sense of economic theory, that is, it is a sufficiently large importer of a good so that its demand has an effect on world price. In this case, a tariff yields a benefit in the form of a lowering of the pre-tariff price of the good. This is a positive terms of trade effect. However, the tariff also causes an offsetting loss because the higher post-tariff price imposes costs on consumer and worsens the allocation of resources among producers. There is still a net gain, provided the tariff rate is moderate and, crucially, its trading partners do not retaliate.

Bagwell and Staiger (2002) produced a "theory of the GATT" which justified reciprocity on the basis that large countries all acting on Optimal Tariff argument lose from tariff rate increases.

But this exception does not explain the behaviour of WTO Ministers. Most countries are small in all markets, i.e. they get no terms of trade benefits from their tariffs and they suffer a net loss from each tariff. Even countries which are economically large - like the US, the EU, Japan and China - have significant market power in only a few markets. There are so many producers in almost all markets with each producing close substitute products that significant monopsony power is rare. For example, Magee and Magee (2008) provide empirical evidence that the US, the largest trader in the world economy, is not a small country in the sense of the optimal tariff argument.

To be blunt about it, it is an economic nonsense to treat offers in WTO negotiations as if the reduction in trade barriers imposes a cost on the economy of the offering country. And it is extremely harmful nonsense as it handicaps the offers which each nation makes at each stage of the negotiations for improved market access in agriculture, Non-agricultural Market Access (NAMA) negotiations (spell out in full) and service markets. At the time the GATT was created more than 60 year ago, however, the gains from unilateral action were not understood[2].

In the current Doha Development Round Developing Country Members collectively have taken the concession view to a higher level. In the NAMA negotiations, they pushed successively for differential and lower coefficients in the NAMA tariff-cutting formula – at the present stage the draft calls for a coefficient in the formula applied to individual tariff lines of [8-9] for Developing Members compared to a coefficient of [19-23] for Developed Members. On top of this, Developing members want greater "flexibility" in nominating lines for some products which would be subject to cuts that are up to only 50 per cent of those given by the formula. Then there is extra special treatment for small and vulnerable economies, and Least Developed Members would not have to make any cuts at all.

These Developing members have in general much higher average tariff levels and in particular much higher peak rates than Developed Members (see WTO Tariff Profiles 2008 database on the WTO website). And they have more non-tariff measures (ntms). Thus, they would stand to gain the most from reducing their levels of protection – but they will be allowed to do the least. This is bad economics. Most of all, it harms the very Developing Members that are seeking this differential treatment.

[2]- In more recent years and in other trade policy actions the Governments of many member countries have not acted on the premise of harmful "concessions". Many Developed countries have unilaterally cut tariff rates and eliminated or reduced costly non-tariff measures affecting trade in goods markets. They have done so in the clear recognition that unilateral action, without reciprocity, is good for the economies of their countries. Many Developing Country Members have done the same. Chile, for one, is an outstanding example of this strategy and a number of countries in East Asia have followed this strategy in the last 20 years or so.

The root of these problems in negotiations is the political economy of cutting tariffs and other non-tariff measures. Losers will form coalitions and lobby governments to obstruct trade liberalisation measures. In this context, multilateral liberalisation based on reciprocity has two benefits. First, reciprocal trade liberalisation will increase the size of the aggregate gains in real income of the participating countries and thereby make the changes more acceptable. Second, the New Trade Theory that emerged after 1980 shows that there will be a simultaneous increase in the exports and imports within industries with multilateral trade liberalisation. This will reduce the extent of losses to individual households. Empirical evidence of increased intra-industry specialisation when trade is liberalised is very strong (World Bank, 2009) .

If there were a greater appreciation of the economics of trade liberalisation, Member countries would be more willing to offer reductions and a successful conclusion of the round would be more likely.

3. Regional Trading Agreements:

Article XXIV of GATT and Article V of GATS allow an exception for the basic GATT/WTO principle of non-discrimination (MFN Treatment) for free trade areas and customs unions. These are collectively known as Regional Trade Agreements or RTAs for short.

The Warwick Commission (2007) noted that the surge in the number of RTAs and their coverage since the mid 1990s has lead to growing concern in the WTO. WTO rules relating to RTAs are being re-examined in the Negotiating Group on Rules but to date the changes mooted are quite minor.

Article XXIV was framed at a time, more than 50 years ago, when the prevailing view was that any movement towards free trade would improve the allocation of world resources. Hence RTAs were to be encouraged.

This view changed when Jacob Viner in his great 1950 book *The Customs Union Issue*. Viner emphasised that the reductions within RTAs is discriminatory and could impose costs on the union countries due to "trade diversion" and it imposes costs

on outside countries through diminished access compared to that of the members of the agreement. This led to the view that RTAs are suspect on economic grounds. However, the views of economists changed again with the publication of the article by Kemp and Wan (1976). They showed that a customs union improves the welfare of all households in all countries under two conditions:

(i) it introduces a system of lump sum payments among members of the union, and

(ii) it adjusts its external tariffs so as to leave the volume of trade with outside countries unchanged.

The first condition ensures that the improvement in the allocation of resources and the increase in aggregate real income within the union is used to ensure that no household in the union is worse off. The second avoids the costs of "trade diversion" for outside countries. Since then the proposition has been shown by Ohyama (2002) and by Panagariya and Krishna (2002) to hold also for free trade areas.

This proposition does refer to potential gains only, conditional upon a system of lumpsum payments. These payments will not in fact be made. But the proposition remains fundamentally important in shaping our view of RTAs. It shifts the balance of opinion firmly back towards RTAs as a welfare-improving movement towards free trade.

The importance of the proposition is that it points the way towards rules that can ensure that RTAs benefit the world as whole. Trade discrimination need not be bad for other countries and the world as whole.

There are several lessons for WTO rules:

- To ensure that outside countries are not harmed, WTO rules need to insist that RTAs are accompanied by simultaneous reductions in MFN tariff rates and other trade restrictions
- Rules of Origin for RTAs should be as liberal as possible to increase the gains to both member and non-member countries
- The commodity coverage and, in particular whether all restrictions on "substantially all trade" are eliminated is not the important issues. Ohyama (2007) has extended the propositions to show that, under generally weak conditions, partial RTAs with limited commodity coverage are also potentially welfare-improving.

This line of thinking is a far cry from the direction of negotiations in the Negotiating Group on Rules.

Above all, the discriminatory nature of all RTAs provides another powerful reason to push ahead vigorously with MFN liberalisation as this will reduce preference margins in all RTAs and give gains from trade beyond those listed above.

4. Anti-dumping Actions:

Article VI of GATT 1994 permits a country in which goods are "dumped" to take anti-dumping actions under certain conditions. These conditions relate to the proof of dumping and the proof of injury or threatened injury.

The orthodox view of international trade economists since the work of Viner (1926) has been that these anti-dumping rules do not make economic sense. In fact, they work against the interests of the anti-dumping-action-imposing countries. Dumping is good because it lowers the price of imports, a terms of trade benefit – provided only that it is not predatory or does not in any way lead to a reduction in supplies form the lowest cost supplying countries, which it rarely does.

There is a huge divide or disjunction between the view of international trade economists and WTO rule-makers in this example. Indeed, the actions of the WTO negotiators in the Uruguay Round considerably worsened the divide as one of the outcomes was the decision to assist Developing countries to introduce anti-dumping legislation. Since the conclusion of the Uruguay Round, many more countries, including Brazil, India and several other Developing country Members have begun to take anti-dumping actions.

The implications of economic theory in this instance are very obvious and simple. The anti-dumping provisions of Article VI should be repealed, making anti-dumping actions illegal under the rules of the organisation. If there are any residual anti-competitive effects of dumping, these should be addressed by national competition laws.

If this reform is unpalatable, the rules should be tightened to prevent abuse of the provisions, as with the US practice of "zeroing". Anti-dumping actions are a regular source of complaint under the WTO's Dispute Settlement Procedures.

Above all, it needs to be emphasised that anti-dumping action is taken at the discretion of the importing country. Shooting oneself in the foot is painful.

5.Concluding Remarks:

This paper has argued that it is time for a rethink of the WTO articles and the modus operandi of WTO multilateral negotiations.

The thrust of this critique should not be misunderstood. It is not a call for disbanding the WTO. The GATT/WTO system has been the underpinnings of the international trade system. But the WTO could be reformed so that it operates more strongly in the interests of its members. This is especially important in the current global crisis that emerged in 2008. In this situation, there is a very real danger of increased protectionism as national governments see protectionism as a measure to stimulate the macro-economy and ignore the beggar-thy-neighbour features of their actions. The GATT was established to provide discipline to prevent this happening and instead to promote continual liberalisation of world trade. A successful conclusion to the Doha Development Round would be a major stimulus to the global macro-economy as well as bringing gains to all participating countries.

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