

# A WORLD TRADING SYSTEM FOR THE TWENTY-FIRST CENTURY

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- GATT performed well for much of the 20<sup>th</sup> century
  - by the time the results of the Uruguay Round had been fully implemented, average tariffs on industrial goods had been reduced to below 4% and quantitative restrictions were largely eliminated
- But challenges to the WTO's position at the top of the world trading system are piling up
  - **China's 2001 accession to the WTO** has challenged an approach to globalization that was designed fundamentally with market economies in mind
  - The rise of **large emerging and developing economies in the world trading system more generally** has placed new demands on a system that traditionally catered to industrialized country interests
  - And the rise of **offshoring and global supply chains** has changed the nature of trade itself
  - More recently the increasing importance of **digital trade** makes WTO rules, crafted in a largely pre-digital world, look out of date
  - And the increasing urgency of addressing **climate change** raises the question of what role the WTO should play in this effort
- Meanwhile
  - **GATT's shallow approach to integration has been eclipsed by deeper forms of integration** with a focus on the trade effects of behind-the-border measures and increasingly on regulatory harmonization as an end in itself
  - And we are now witnessing **a strong backlash against globalization**, from those who have not shared in the gains, and from those who feel that the sovereignty of their governments has been eroded
- Do we need a new world trading system to meet the challenges of the 21<sup>st</sup> century?

# Approach and Main Takeaways

- To answer this question, I adopt a basic premise from the literature on the economics of trade agreements
  - The design of a trade agreement should reflect its purpose, the “problem” it is supposed to “solve”
- I consider the purpose of a trade agreement in a world stripped of the 21<sup>st</sup> century challenges enumerated above
  - I argue that the fundamental design features of GATT are well-equipped to serve this purpose
  - and I argue that this harmony between purpose and design can help account for the success of the GATT/WTO in the 20<sup>th</sup> century
- I then ask: Do any of these 21<sup>st</sup> century challenges change the purpose of a trade agreement?
  - The answers can illuminate the nature of the challenges faced by the WTO and the world trading system
- I argue that the logic of GATT’s design transcends many, though not all, of the current challenges faced by the WTO

⇒ The best advice for designing a world trading system for the 21<sup>st</sup> century may not be “Move fast and break things,” but rather Keep Calm and Carry On

# A key starting point: Purpose

- The WTO's legitimacy is not built on the case for free trade
  - rather, it's built on the case for internalizing the international externalities emanating from unilateral trade policy choices
  - if these externalities can be internalized by each country's policy makers, the trade policy choices that countries make will be efficient as judged by their own policy preferences
- Spoiler Alert
  - If the GATT/WTO was well-designed to handle the international policy externalities in the 20<sup>th</sup> century,
  - and if the 21<sup>st</sup> century challenges faced by the WTO do not change the nature of these externalities,
  - then the WTO will be well-designed to handle the challenges of the 21<sup>st</sup> century
- In a broad set of environments that have been studied by economists, the nature of the international policy externality is the same
  - countries that have market power over international prices (their "terms of trade" with the world) can shift a portion of the costs of their trade restrictions onto trading partners
  - this cost-shifting leads to a problem: acting on their own, countries tend to choose overly protective policies relative to efficient policies as judged by their own policy preferences

⇒ The purpose of a trade agreement according to the TOT theory:

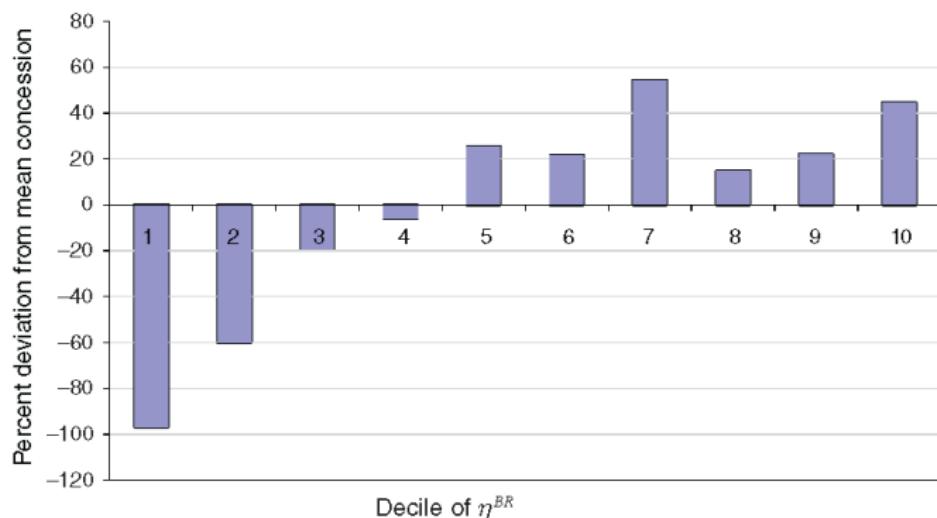
- To eliminate market power/cost-shifting considerations from unilateral tariff choices and expand market access to efficient levels,
- and thereby to provide an escape from a terms-of-trade driven Prisoner's Dilemma

# The World Trading System of the Twentieth Century: Design

- The basic architecture of GATT seems well designed to serve this purpose with a minimal sacrifice of national sovereignty (Bagwell and Staiger, 1999, 2001b, 2002, 2018b)
  - the international externality is pecuniary, and the design of GATT exploits this feature
- The GATT pillars of **MFN** and **reciprocity** simplify the tariff bargaining problem
  - the MFN rule (nondiscrimination) alters the structure of the international externality, extending the simplicity of the 2-country terms-of-trade externality to a many country world
  - reciprocity (a proportionate response to the tariff changes of trading partners) helps to stabilize the terms of trade, and directs the focus of bargaining away from terms-of-trade (zero sum) movements
- And the economic logic of **shallow integration** is sound [Details]
  - a tariff is the perfect instrument for manipulating the terms of trade
    - ⇒ According to the TOT theory, noncooperative (Nash) tariffs are inefficiently high, but by the targeting principle Nash non-tariff policies are efficient, conditional on Nash trade volume (Meade, 1955)
- In theory, a trade agreement could focus on lowering tariffs as a means of expanding market access ("conditions of competition") and trade volumes to efficient levels
  - And put in place various "market access preservation rules" that apply to non-tariff policies and prevent governments from using non-tariff policies to back-slide on their market access commitments
- Under GATT's approach, countries negotiate tariff bindings to make market access commitments, and GATT Articles provide the accompanying market access preservation rules
  - For example, Petersmann's (1997, p. 136) observes that "...the function of most GATT rules (such as Articles I-III and XI) is to establish conditions of competition and to protect trading opportunities..."

# The World Trading System of the Twentieth Century: Evidence

- Many papers provide evidence that GATT/WTO design features have helped governments achieve this purpose
  - Here I highlight three: Bagwell and Staiger (2011), Bagwell, Staiger and Yurukoglu (2020, 2021)
- Bagwell and Staiger (2011) focus on 16 countries that negotiated accession to the WTO after its creation in 1995 and ask whether their agreed tariff cuts reflect the removal of market power considerations from their unilateral tariff choices
  - If so, their agreed tariff cuts should be increasing in their measured market power  $\eta^{BR}$



# Meeting the Challenges of the Twenty-First Century

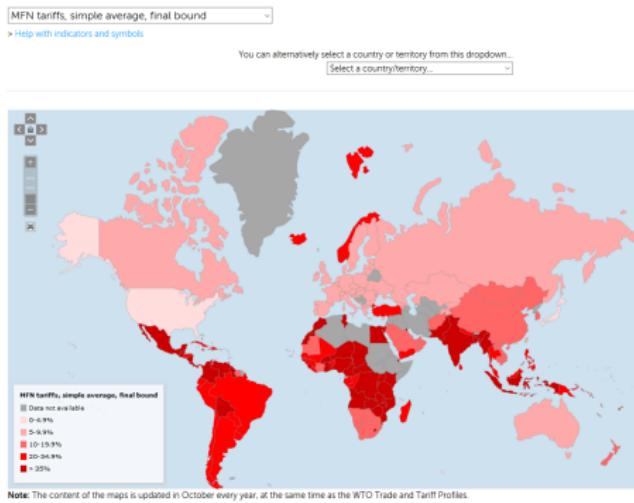
- The design of a trade agreement should reflect its purpose, the “problem” it is supposed to “solve”
- In a world stripped of its 21<sup>st</sup> century challenges the purpose of a trade agreement is to help governments escape from a terms-of-trade driven Prisoner’s Dilemma
  - I have argued that the fundamental design features of GATT are well-equipped to serve this purpose
  - And I have argued that this harmony between purpose and design can help account for the success of the GATT/WTO in the 20<sup>th</sup> century
- I now ask: Is the purpose of a trade agreement different in the 21<sup>st</sup> century?
  - If so, then fundamental changes to the design of the world trading system may be needed
  - If not, then the fundamental design of the GATT/WTO should be adequate to meet the challenges of the 21<sup>st</sup> century
- Below I consider
  - The rise of large emerging markets, led by China (and the return to protectionism)
  - Accommodating efforts to address climate change
  - Digital trade
  - The rise of offshoring and global value chains
  - The push for regulatory harmonization as an end in itself
  - Some remaining elephants in the room

# The Rise of Large Emerging Markets, Led by China

- Three interrelated challenges
- I) Non-reciprocity and the rebalancing of market access commitments with China
  - China's 2001 accession to the WTO has challenged an approach to globalization that was designed fundamentally with market economies in mind
  - But the presence of a "China, Inc." does not change the purpose of a trade agreement
  - What it does change is the nature of the commitments that China must make to translate its tariff bindings into secure market access commitments
  - The non-violation clause provides a promising path to address the current impasse, with China not asked to adopt market reforms but instead given maximum autonomy to decide how best to guarantee its market access commitments (e.g., Poland's protocol of accession to GATT)
- II) Reconsideration by industrialized countries of the level of market access commitments they agreed to implement in 1995
  - Those industrialized countries that have experienced a significant increase in income inequality over the past several decades may now want to reconsider some of their existing tariff commitments
  - Article XXVIII renegotiations provide the liability-rule structure to achieve "efficient breach" of tariff commitments made in 1995 (different from Brexit)

# The Rise of Large Emerging Markets, Led by China

- III) Solving the “latecomers problem” (Bagwell and Staiger, 2014) and better integrating the large emerging market economies into the world trading system



- Countries need the negotiating flexibility to transition toward the set of tariff commitments that the current WTO membership would have chosen to negotiate were they not constrained in their negotiations by their pre-existing tariff bindings
  - Article XXVIII renegotiations together with Article XXVIII bis negotiations provide countries with the flexibility to escape from their existing GATT/WTO tariff bindings in an orderly way when necessary, in order to then engage in reciprocal MFN tariff bargaining with all willing partners

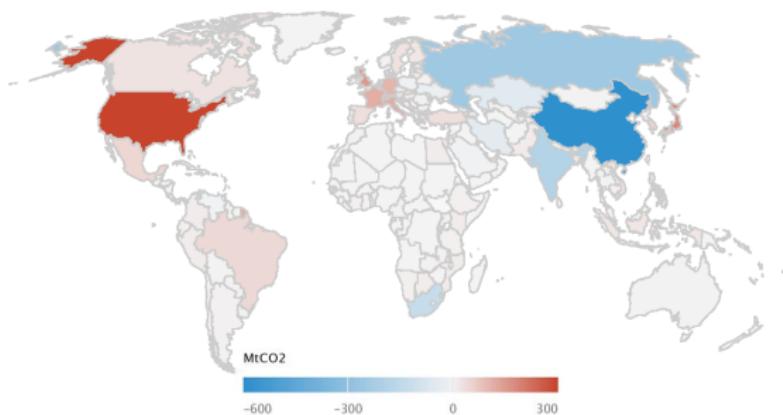
# Accommodating Efforts to Address Climate Change

- The WTO is well-suited to accommodate efforts to address climate change
- First, suppose countries find a way to negotiate an enforceable climate accord that implements the increase in carbon taxes necessary to solve the climate problem
- According to the terms-of-trade theory, GATT's shallow approach to integration can accommodate the solution to the climate problem while maintaining the solution to the trade problem
  - provided that carbon border adjustments are used to offset the competitive effects that the implementation of higher carbon taxes would otherwise create for each country
- The role of carbon border adjustments according to the terms-of-trade theory resonates with the role as seen from the perspective of the policy debate
  - namely as a mechanism for addressing trade competitiveness impacts and "carbon leakage" concerns that arise when a country considers implementing more stringent carbon policies
- But there is a key difference: according to the terms-of-trade theory, these carbon border adjustments do *not* depend on the carbon content of the production of one's trading partners
  - These adjustments moderate the market access implication of a country's own increase in carbon taxes, and keep its market access at an efficient level as its carbon tax is raised to the efficient level
  - And while the market access implication of a country's carbon tax increase reflects the carbon content of its *own* production, it has nothing to do with carbon content in the country's trading partners

# Accommodating Efforts to Address Climate Change

- Second, carbon border adjustments would create additional MFN tariffs in industrialized countries that could be cut in exchange for reciprocal tariff cuts from large emerging markets

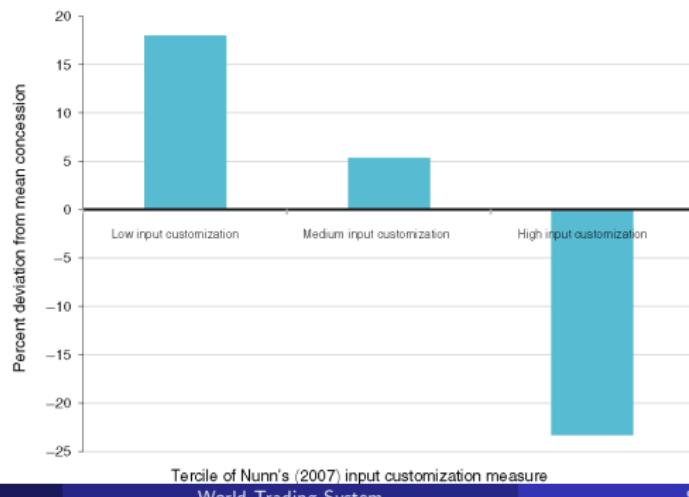
CO2 imports and exports from trade, 2014



- could help solve the latecomers problem
- could help with enforcement of climate commitments, since indirectly the tariff cuts from large emerging markets would be contingent on the increase in carbon taxes promised by industrialized countries

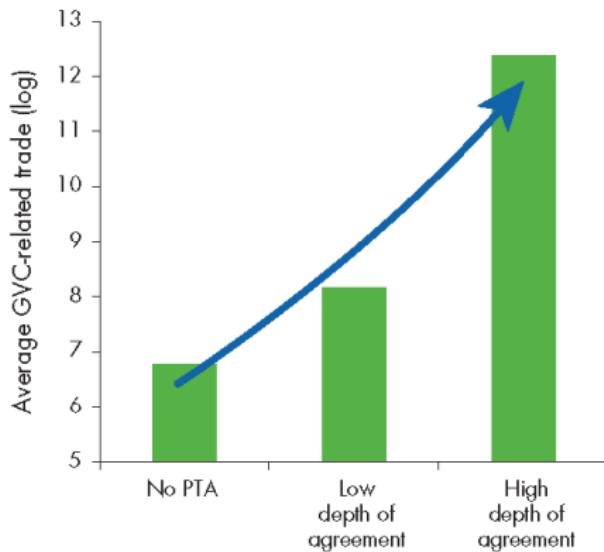
# The Rise of Offshoring and Global Value Chains

- Does offshoring create new problems of global policy cooperation whose solutions require international agreements with novel features?
- Trade in inputs per se does not change the purpose of a trade agreement
  - as long as international prices are still determined by the forces of supply and demand through market clearing conditions
- But trade in highly customized inputs may change the purpose of a trade agreement
  - if the nature of international price determination is altered, so that the tariff is no longer the perfect instrument for terms-of-trade manipulation (Antrás and Staiger, 2012a, 2012b)
  - In that case, GATT/WTO architecture not well-suited for achieving efficient liberalization



# The Rise of Offshoring and Global Value Chains

- If buyers bargain bilaterally with their foreign suppliers over the price at which customized inputs are exchanged, more than just tariffs will be set inefficiently in the Nash equilibrium
  - Nash behind-the-border policies will also be distorted to achieve favorable international prices, and the logic of shallow integration is disrupted
  - Countries may then seek deep trade commitments that the WTO framework cannot provide in order to facilitate the trade in customized inputs that dominate GVCs (Laget et al, 2019, World Bank, 2020)



⇒ The rise of offshoring could necessitate fundamental changes to the design of the WTO, but thus far the evidence for this is only suggestive and indirect

- **What are the sovereign rights of nations in an interdependent world**, and to what extent do these rights stand in the way of achieving internationally efficient outcomes?
- Bagwell and Staiger (2018b) propose a formal definition of sovereignty based on the Westphalian norm of non-intervention in the internal affairs of other states
  - Where the terms-of-trade theory applies, an agreement that emphasizes non-discriminatory market access commitments can achieve international policy efficiency while preserving national sovereignty
  - The further the WTO and the world trading system that it governs departs from this approach, the more likely will these agreements pose a (possibly avoidable) threat to national sovereignty
- **Does the WTO need a hegemon to survive?**
- Mattoo and Staiger (2020) argue that a rules-based system is tenable only in the presence of a dominant hegemon who can reap the participation benefits from having its hands tied
  - The diminished position of the United States in the world economy may help explain the erosion of US support for the WTO and bodes poorly for the future of the rules-based multilateral trading system
  - And China's rise may ultimately be the world's best hope for the return of a viable rules-based system
- **What is the WTO's role in preparing for the next pandemic?**
- The self-enforcement constraints (as in Bagwell and Staiger, 1990) faced by the WTO are likely to be extreme with the onset of a pandemic
  - This suggests that the WTO's role in preventing export restrictions during a pandemic will be limited
  - And the WTO may be most effective in helping countries cooperate over measures that could reduce the probability of pandemics in the first place, perhaps partnering with the WHO in this effort

# A World Trading System for the Twenty-First Century

- I have argued that **the terms-of-trade theory of trade agreements** provides a compelling framework for understanding the success of GATT in the 20<sup>th</sup> century
- I have argued that according to this understanding the logic of **GATT's design transcends many, though not all, of the current challenges faced by the WTO**
- More broadly, two cross-cutting themes that emerge from the terms-of-trade theory of trade agreements are worth emphasizing for the world trading system of the 21<sup>st</sup> century
- **Trade agreements that lack deep-integration provisions are not necessarily “weak” agreements;** and by the same token, those trade agreements that contain the most developed deep-integration provisions should not necessarily be seen as the “gold standard”
  - Where the terms-of-trade theory applies the opposite may be closer to the truth, as with shallow-integration agreements countries might attain efficient policies without sacrificing national sovereignty
  - Viewed from this perspective, the fact that the WTO lags behind various regional initiatives to deepen the negotiated commitments of its member governments may be a virtue rather than a shortcoming
- It could be argued that **the primary task for the GATT/WTO has shifted**, away from helping governments traverse *to* the efficiency frontier and toward providing them with the flexibility they need to remain *on* the frontier in the face of various shocks to the world trading system
  - For this era the capabilities of countries to rebalance and renegotiate their commitments within the GATT/WTO framework is likely to become paramount to the WTO's success
  - In principle the WTO is as well-equipped for this second task as GATT proved to be for the first
- ⇒ The best advice for designing a world trading system for the 21<sup>st</sup> century may not be “Move fast and break things,” but rather ...



KEEP  
CALM  
AND  
CARRY  
ON

## Extra Material

# The World Trading System of the Twentieth Century: Design Details

- The terms-of-trade theory provides a simple framework within which to interpret two of the most basic features of GATT tariff negotiations
- I) Provides a reason why negotiators would view own-tariff cuts as “concessions” and seek foreign tariff cuts for their exporters

- two-good two-country competitive general equilibrium trade model
- gov objectives  $W(p(\tau, \tilde{p}^w), \tilde{p}^w)$  and  $W^*(p^*(\tau^*, \tilde{p}^w), \tilde{p}^w)$  satisfying  $W_{\tilde{p}^w} < 0 < W_{\tilde{p}^w}^*$
- Nash tariffs satisfy

$$W_p \frac{dp}{d\tau} + W_{\tilde{p}^w} \frac{d\tilde{p}^w}{d\tau} = 0; \quad W_{p^*}^* \frac{dp^*}{d\tau^*} + W_{\tilde{p}^w}^* \frac{d\tilde{p}^w}{d\tau^*} = 0$$

⇒  $W_p < 0 < W_{p^*}^*$  at Nash tariff choices; own-tariff cut a concession but matched with foreign tariff cut we can both gain

- Suggests the utility of a reciprocity rule that balances tariff cuts so as to leave  $\tilde{p}^w$  unchanged

# The World Trading System of the Twentieth Century: Design Details

- II) Provides basis for narrow focus on tariff negotiations

- a domestic standard in each country,  $\sigma$  and  $\sigma^*$ , impacts that country's production possibilities, implying  $\tilde{p}^w = \tilde{p}^w(\sigma, \sigma^*, \tau, \tau^*)$
- gov objectives  $W(\sigma, p(\tau, \tilde{p}^w), \tilde{p}^w)$  and  $W^*(\sigma^*, p^*(\tau^*, \tilde{p}^w), \tilde{p}^w)$  satisfying  $W_{\tilde{p}^w} < 0 < W_{\tilde{p}^w}^*$

- Conditions for efficient policy choices

$$\frac{[\tau W_p + W_{\tilde{p}^w}] \frac{\partial \tilde{p}^w}{\partial \tau^*}}{W_p \frac{dp}{d\tau} + W_{\tilde{p}^w} \frac{\partial \tilde{p}^w}{\partial \tau}} = \frac{W_{p^*}^* \frac{dp^*}{d\tau^*} + W_{\tilde{p}^w}^* \frac{\partial \tilde{p}^w}{\partial \tau^*}}{[\frac{1}{\tau^*} W_{p^*}^* + W_{\tilde{p}^w}^*] \frac{\partial \tilde{p}^w}{\partial \tau}}$$

$$W_\sigma + W_p \frac{dp}{d\tau} \frac{d\tau}{d\sigma} \Big|_{d\tilde{p}^w=0} = 0 \text{ and } W_{\sigma^*}^* + W_{p^*}^* \frac{dp^*}{d\tau^*} \frac{d\tau^*}{d\sigma^*} \Big|_{d\tilde{p}^w=0} = 0$$

- Top condition describes efficient trade volumes; bottom conditions describe each country's efficient policies to deliver this trade volume
- Nash violates top condition  $\Rightarrow$  tariffs too high/trade volumes too low
- Nash satisfies bottom conditions  $\Rightarrow$  conditional on trade volumes, Nash policy choices efficient

➡ Shallow integration

- expand market access to efficient levels with tariff commitments
- apply "market access preservation" rules to subsequent policy adjustments
- and achieve policy efficiency

- Terms-of-trade theory also provides a basis for understanding nature of interdependence in a multilateral world
- Two-good three-country competitive general equilibrium trade model
  - Home exports  $y$  to  $*1$  and  $*2$  and imports  $x$  from  $*1$  and  $*2$
- Discriminatory home tariffs  $\tau^1 \neq \tau^2$  imply that  $p^{w1} \neq p^{w2}$  through  $p = \tau^1 p^{w1} = \tau^2 p^{w2}$ , hence home has distinct terms of trade with  $*1$  and  $*2$
- But MFN requires  $\tau^1 = \tau^2 \equiv \tau$ , hence  $p^{w1} = p^{w2} \equiv \tilde{p}^w(\tau, \tau^{*1}, \tau^{*2})$ 
  - Gov objectives still  $W(p, \tilde{p}^w)$ ,  $W^{*1}(p^{*1}, \tilde{p}^w)$ ,  $W^{*2}(p^{*2}, \tilde{p}^w)$ , externality still travels through  $\tilde{p}^w$
- But each country's welfare impacted by the tariff choices of the remaining *two* countries through  $\tilde{p}^w(\tau, \tau^{*1}, \tau^{*2})$ 
  - In general a collection of bilateral MFN tariff negotiations represents a setting of bilateral bargaining with externalities

"[T]he restoration of greater freedom for international trade and factor movements can be made meaningful only by means of international agreements which cut rather deeply into domestic economic arrangements. One cannot hope to see the abandonment of protective devices except in the framework of all-round international agreement, since unilateral action is quite likely to cause the free-trade country to lose more from a deterioration in its terms of trade than it gains from the expansion of trade. But as soon as any attempt is made to limit protective devices, a whole host of domestic economic arrangements must be brought under examination. Tariffs and quantitative import restrictions are not the only means for protecting domestic industries. Subsidies, domestic taxes, domestic price and quantity controls, nationalization schemes – all can be used for similar purposes. Yet all of these instruments may be perfectly legitimate instruments of policy for the attainment of certain other perfectly legitimate objectives. ... If a more liberal international economy is to be established by international agreement, one must search for a working compromise between the need effectively to curb protective devices and the need to give national governments freedom to adopt effective domestic economic policies for the attainment of legitimate domestic objectives."

– The Theory of International Economic Policy, Volume Two: Trade and Welfare, by J. E. Meade. Oxford University Press, London: 1955, p 570.

## ANNEX B

### Draft Schedule LXV - Poland

1. Subject to paragraph 2 below, Poland shall, with effect from the date of this Protocol, undertake to increase the total value of its imports from the territories of contracting parties by not less than 7 per cent per annum.
2. On 1 January 1971 and thereafter on the date specified in paragraph 1 of Article XXVIII of the General Agreement Poland may, by negotiation and agreement with the CONTRACTING PARTIES, modify its commitments under paragraph 1 above. Should this negotiation not lead to agreement between Poland and the CONTRACTING PARTIES, Poland, shall, nevertheless, be free to modify this commitment. Contracting parties shall then be free to modify equivalent commitments.

- I next describe results from Bagwell, Staiger and Yurukoglu (2020a)
- Many GATT rounds utilized bilateral tariff bargaining, where requests for market access were matched by reciprocal offers, and with the results multilateralized according to MFN
  - According to the terms-of-trade theory, this approach to tariff bargaining can eliminate strategic bargaining behavior (Bagwell and Staiger, 2018a)
- The absence of strategic bargaining behavior is seen by GATT practitioners and legal scholars as a hallmark of the tariff bargaining that occurred in the early GATT rounds and as distinguishing GATT tariff bargaining from the tariff bargaining that preceded it
  - *...Their requests cannot be higher than their offers and negotiations start from this maximum position: if all requests are granted all the offers will be fulfilled. Similarly all other contracting parties are likely to make offers which match the requests they have made. As some of the requests are rejected, some of the offers are withdrawn. This procedure has been raised to a Gatt principle and is not laid down by any rule. It is a convention but one which creates a much better negotiating climate than the opposite trend which was a feature of the classical bilateral negotiations. Then, everyone put forward very low offers with the intention of increasing gradually if the bargaining proved profitable. A country never knew, however, when it had reached the maximum its partner was willing to concede. Curzon (1966, p. 74)*

# Multilateral Trade Bargaining

- Curzon describes a tariff bargaining forum in which there is no point in making lowball initial offers, because governments are expecting non-strategic behavior from their bargaining partners and such offers would simply be taken at face value
- For GATT oldtimers
  - The initial offer made by a country ("sales") reduced tariffs to 0.808 of the existing tariff level while the final offer made reduced tariffs to 0.806 of the existing tariff level
  - The initial offer received by a country ("purchases") reduced tariffs to 0.817 of the existing tariff level while the final offer received reduced tariffs to 0.802 of the existing tariff level

		Sales			Purchases		
		Ad Val	Specific	All	Ad Val	Specific	All
		Country-Specific					
Initial request over existing tariff	Mean	0.543	0.577	0.554	0.512	0.582	0.539
	SD	0.235	0.306	0.260	0.257	0.321	0.286
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	17681	7971	25652	15621	9911	25532
Initial offer over existing tariff	Mean	0.804	0.817	0.808	0.796	0.845	0.817
	SD	0.195	0.233	0.208	0.213	0.218	0.216
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	8387	3577	11964	6578	5008	11586
Final agreed concession over existing tariff	Mean	0.797	0.827	0.806	0.773	0.831	0.802
	SD	0.200	0.235	0.212	0.211	0.240	0.228
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	5603	2394	7997	3384	3341	6725

# Multilateral Trade Bargaining

- Several newcomers to GATT unaware of this new technique and starting with low offers found that in the course of negotiations they were unable to reach the level of requests they aimed for. Their initially low offers were taken as proof of their intentions and they either had to go home with a tariff higher than expected or had to increase their offers in the course of the negotiations. Curzon (1966, p. 74)

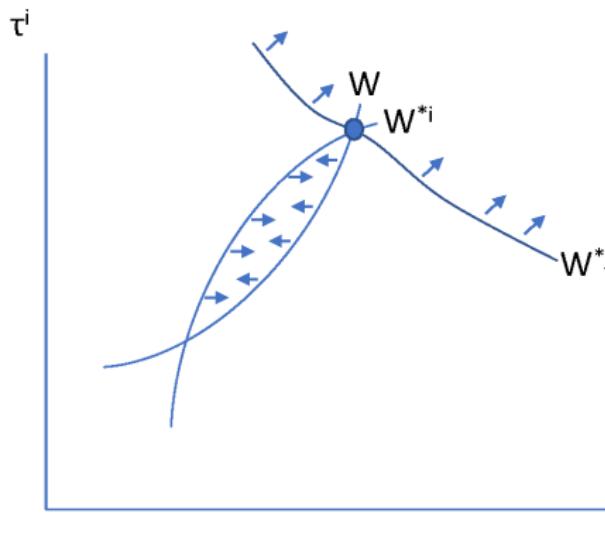
- GATT newcomers

- The initial offer made by a country ("sales") reduced tariffs to 0.855 of the existing tariff level while the final offer made reduced tariffs to 0.819 of the existing tariff level
- The initial offer received by a country ("purchases") reduced tariffs to 0.833 of the existing tariff level while the final offer received reduced tariffs to 0.820 of the existing tariff level

	Sales			Purchases			
	Ad Val	Specific	All	Ad Val	Specific	All	
Country-Specific							
Initial request	Mean	0.471	0.611	0.544	0.571	0.617	0.585
	SD	0.294	0.327	0.319	0.223	0.290	0.246
over existing	Min	0	0	0	0	0	0
tariff	Max	1	1	1	1	1	1
	N	4306	4696	9002	6366	2756	9122
Initial offer over	Mean	0.827	0.870	0.855	0.829	0.840	0.833
existing tariff	SD	0.229	0.203	0.213	0.179	0.225	0.197
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	1798	3445	5243	3607	2014	5621
Final agreed	Mean	0.725	0.846	0.819	0.807	0.849	0.820
concession over	SD	0.179	0.241	0.234	0.183	0.232	0.201
existing tariff	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	668	2271	2939	2887	1324	4211

# Quantitative Analysis of Multiparty Tariff Negotiations

- And finally, I consider what we know about tariff bargaining in the absence of GATT rules
- I describe results from Bagwell, Staiger and Yurukoglu (2021) who ask: Could GATT tariff negotiations have performed better if MFN had been abandoned?
  - MFN can create a free rider problem in bilateral tariff bargaining settings (a positive 3<sup>rd</sup>-party externality) that keeps countries from liberalizing all the way to the efficiency frontier
  - But in the absence of MFN and beginning from any point on the efficiency frontier, there is an incentive for each bilateral pair of countries to over-liberalize on a discriminatory basis and steal surplus from third countries (a negative 3<sup>rd</sup>-party externality)



# Quantitative Analysis of Multiparty Tariff Negotiations

- Which 3<sup>rd</sup>-party externality is more damaging?

TABLE VII  
ESTIMATED URUGUAY ROUND AND COUNTERFACTUAL OUTCOMES<sup>a</sup>

	Estimated Bargaining Parameters		All 0.5 Bargaining Parameters	
	MFN	No MFN	MFN	No MFN
	Δ% 1990	Δ% 1990	Δ% 1990	Δ% 1990
Δ Mean Tariff	-30.22%	-28.85%	-29.22%	-28.59%
Δ Trade Wgt'd Mean Tariff	-19.54%	-130.36%	-19.11%	-131.27%
Country Welfare				
US	0.01%	-0.13%	0.02%	0.11%
EU	0.02%	0.06%	0.03%	0.08%
Japan	0.10%	0.32%	0.06%	-0.24%
South Korea	0.17%	0.15%	0.32%	0.04%
Australia	0.06%	-1.71%	0.07%	0.18%
Canada	0.02%	-0.49%	0.02%	-0.59%
Africa NES	0.03%	-0.08%	0.02%	-0.09%
America NES	0.02%	-0.05%	0.02%	-0.04%
Asia NES	0.15%	-0.37%	0.17%	-0.33%
Europe NES	0.02%	-0.12%	0.02%	-0.16%
MENA NES	0.01%	-0.28%	0.00%	-0.49%
Mean	0.10%	-0.21%	0.11%	-0.19%
World Real Income	0.06%	-0.02%	0.06%	-0.07%

<sup>a</sup>Notes: Each column represents changes in the row relative to the pre-Uruguay tariff levels. Tariff averages are computed among nonagriculture sectors for the bargaining countries. The mean across countries is weighted by population.

- The WTO is better designed to deal with digital trade than is commonly believed
- Where the non-pecuniary externalities associated with digital openness (related to issues such as privacy, national security and law enforcement) are purely local
  - The purpose of a trade agreement for both trade in goods and trade in services is unchanged by the advent of the digital world
  - This implies that the existing shallow-integration features of GATT can in principle be applied to digital policies impacting goods trade in such a world
  - And while GATS is a deep-integration agreement, a GATT-like shallow-integration approach to trade in services is possible along the lines suggested by Staiger and Sykes (2021), and could be applied to digital policies impacting services trade as well
  - With digital trade blurring the distinction between goods and services, the redesign of GATS to bring it closer to the design of GATT could be all the more attractive
- Where the non-pecuniary externalities associated with digital openness cross international borders
  - The purpose of a trade agreement is more complex
  - But even in this case there may be an approach to integration for goods and services trade in a digital world that lies somewhere between the WTO's shallow integration approach and a fully deep approach

# The Push for Regulatory Harmonization

- In his 2015 Jan Tumlr Lecture, former WTO Director General Pascal Lamy emphasized the growing importance of a particular form of international externality, different from market access issues and arising instead from regulatory heterogeneity across countries
  - Lamy argued that, with traditional trade barriers now reduced to low levels, the protectionist motive for insulating producers from foreign competition is being replaced by the precautionary motive for regulation designed to protect consumers' health, safety and values
  - And as a result, according to Lamy, trade agreements are becoming less about eliminating protective barriers and more about reducing differences between regulatory policies that have legitimate aims, in pursuit of the cost savings that such regulatory harmonization implies
- Yet as Sykes (1999a, 1999b) observes, international differences in incomes, cultures, risk preferences and tastes generally justify some degree of regulatory heterogeneity, even if the added costs of satisfying a multitude of rules are also recognized
- What is the appropriate balance between the reduction of regulatory differences across countries to lower the costs of serving multiple markets and the preservation of regulatory differences across countries to reflect their heterogeneous tastes?
  - What role, if any, might a trade agreement play in helping countries achieve this balance, and how should the agreement be designed to serve that role?
- The terms-of-trade theory cannot take us very far in answering these questions
  - according to that theory, harmonizing regulations would be desirable only to the extent that it is needed to secure the property rights over negotiated market access, not as an end in itself

# The Push for Regulatory Harmonization

- Here I discuss the findings of Grossman, McCalman and Staiger (2021), who propose a novel modelling framework that can provide answers to these questions
  - Traditional market access/terms-of-trade manipulation concerns are put to the side
  - Firms design products to appeal to local tastes, which differ across countries as Sykes emphasizes
  - But the firms' fixed costs increase with the differences between versions of their products destined for different markets, and hence there are potential cost savings from regulatory harmonization as emphasized by Lamy
- Countries have a “delocation” motive (Venables, 1987, Ossa, 2011) to confront foreign firms with product standards that are far away from the standards in their home markets
  - ⇒ To achieve efficiency, a trade agreement must achieve regulatory harmonization
- In the absence of (local) consumption externalities, shallow integration can achieve efficiency
  - But mutual recognition, not national treatment as under current GATT/WTO design, must be adopted
- In the presence of (local) consumption externalities, the case for shallow integration breaks down, and efficiency can only be achieved with direct negotiations over product standards
  - The choices of product attributes made by one country's firms interact with the (local) consumption externalities in other countries, independent of the market magnitudes induced by these choices
  - The problem for a trade agreement to solve goes beyond market access issues

⇒ Countries might negotiate selectively over standards where externality problems are present, and rely on some combination of national treatment and the non-violation clause combined with mutual recognition to achieve efficiency for standards that are not directly negotiated