

# **Economics of the GATT/WTO**

# **“GATT-Think”**

- **“...So if our theories really held sway, there would be no need for trade treaties: global free trade would emerge spontaneously from the unrestricted pursuit of national interest...” (Krugman, 1997)**
- **Why then in trade negotiations does a government “...require a ‘concession’ from its trading partner(s) in order to do what is in any event best for the country”? (Bagwell and Staiger, 1999)**
- **Observation that governments seek reciprocity in trade agreements often interpreted to mean trade negotiators are adopting a mercantilist perspective inconsistent with economic logic**

# “GATT-Think”

- Krugman (1991) observes that there are three simple rules about the objectives of negotiating countries:
  - exports are good
  - imports are bad
  - *ceteris paribus*, an equal increase in imports and exports is good
- “GATT-think is “enlightened mercantilism”, i.e., it is *mercantilist* in presuming countries unilaterally like to subsidize exports and tax imports, and *enlightened* in recognizing this could be destructive
- “GATT-think” sees trade policy problem as one where individually countries have an incentive to be protectionist, yet collectively they gain from free trade

# **“GATT-Think”**

- **What is hidden logic of “GATT-think”?**
- **Based on political pressure arguments, government policy does not necessarily represent public interest, but rather well-organized groups such as exporters and import-competing producers – explains first two principles of “GATT-think”**
- **Despite ignoring gains from trade as economists understand them, in setting exporter interests as a counter-weight to import-competing interests, and by bargaining for access to each others’ markets, trade negotiators do move system closer to free trade**
- **Since 1947, through 8 rounds of GATT, average *ad valorem* tariffs cut from 40 to 4%, and GATT/WTO membership has risen to 157 countries**

# Where is the WTO at present?

- **December 2013, WTO agreement on “trade facilitation” – essentially measures to simplify customs rules**
- **While lauded in media as a breakthrough in Doha Round, it has not pushed forward typical agenda of tariff-cutting**
- **Raises question(s) of why a multilateral agreement, similar to those concluded under GATT, not reached under its successor**
- **Focus here on two themes:**
  - **Is the WTO subject to a “latecomers” problem?**
  - **Are activities such as offshoring pushing countries to seek “deep integration” via preferential trade agreements (PTAs)?**

# What is the function of the WTO?

- **Standard result is that where country is small, first-best outcome is free trade, i.e., tariffs are not optimal**
- **So why would countries pursue reciprocal tariff-cutting through the WTO?**
- **Countries may be able to influence their terms of trade through tariffs, i.e., they have *monopsony/monopoly* power – Johnson (1954)**
- **Supported by empirical evidence (Broda *et al.*, 2008)**
- **This result, along with political-economy considerations, has informed modern analysis of WTO as resolution of a terms-of-trade Prisoner's Dilemma (Bagwell and Staiger, 1999)**

# Basic argument

- Assume “home” country imports  $x$  on which it levies tariff  $t$ , and “foreign” country imports  $y$  on which it levies tariff  $t^*$
- $p = p_x/p_y$  and  $p^* = p_x^*/p_y^*$  are domestic relative prices, where  $p_x = p_x^*(1+t)$ , and  $p_y = p_y^*(1+t^*)$ , where  $\delta p/\delta t > 0 > \delta p^*/\delta t^*$
- $p^w = p_x^*/p_y$  is world relative price, where  $\delta p^w/\delta t < 0 < \delta p^w/\delta t^*$
- Home and foreign welfare are:  $W(p, p^w)$ , and  $W^*(p^*, p^w)$ , where  $\delta W(p, p^w)/\delta p^w < 0$ , and  $\delta W^*(p^*, p^w)/\delta p^w > 0$ , i.e., improved terms of trade raise welfare
- With unilateral policies, tariffs chosen to maximize:

$$W_p + \lambda W_{p^w} = 0 \quad (1)$$

$$W_p^* + \lambda^* W_{p^w}^* = 0 \quad (2)$$

where  $\lambda = [\delta p^w/\delta t]/[\delta p/\delta t] < 0$  and  $\lambda^* = [\delta p^w/\delta t^*]/[\delta p^*/\delta t^*] < 0$

# Basic argument

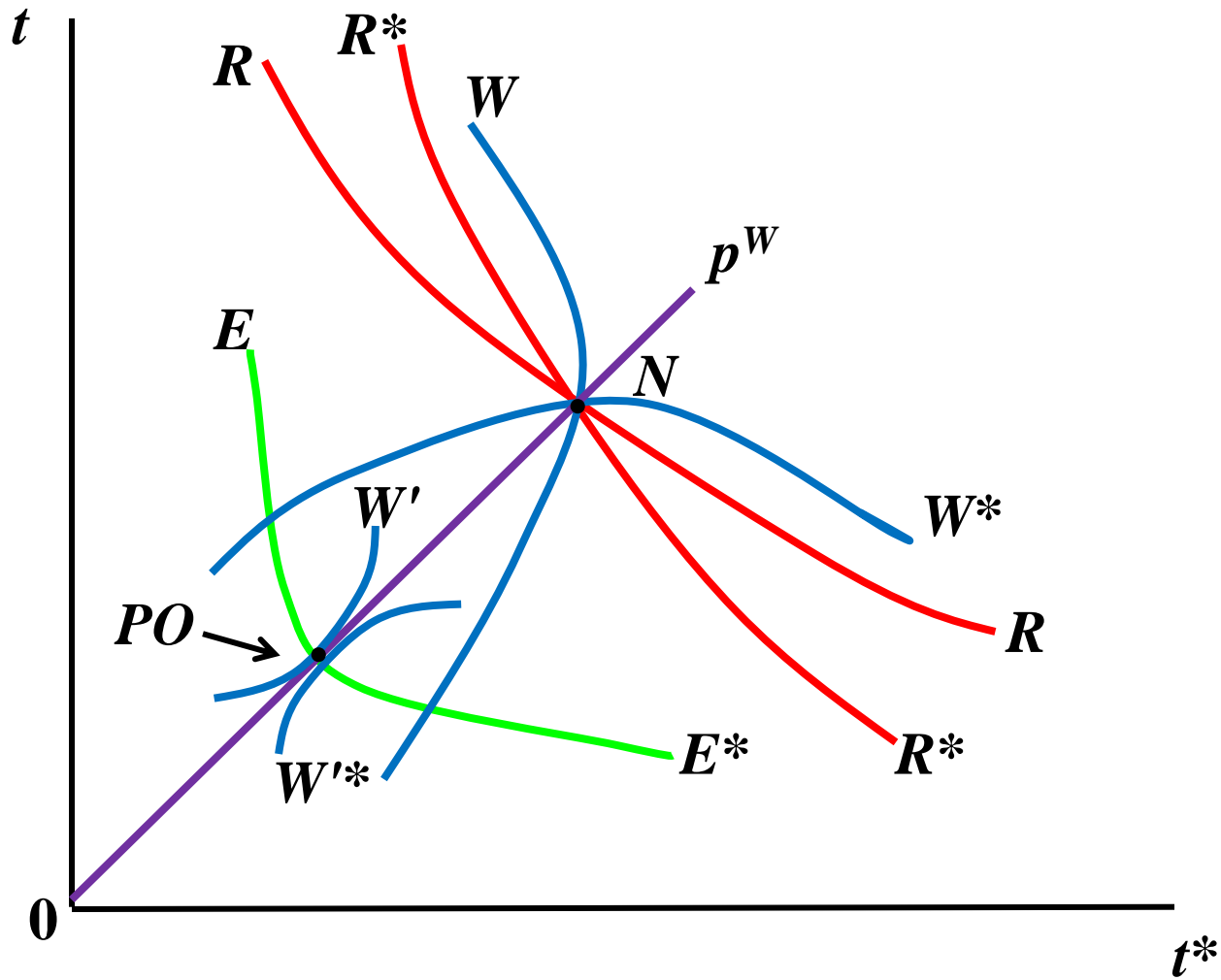
- (1) and (2) are tariff reaction functions, each government striking balance over effect of tariff on local and world-prices
- Nash equilibrium inefficient as each country attempts to shift costs of policy choice onto other country – WTO is mechanism by which tariffs are cut reciprocally to efficient level
- If terms-of-trade effects do not matter to either government, politically optimal tariffs satisfy,

$$W_p = 0, \text{ and } W^*_p = 0$$

- Allows for possibility that tariffs are zero if objective of governments is to maximize national income, i.e., free trade
- Reciprocal tariff-cutting through WTO is Pareto-improving, terms-of-trade externality being neutralized



# Tariff equilibrium



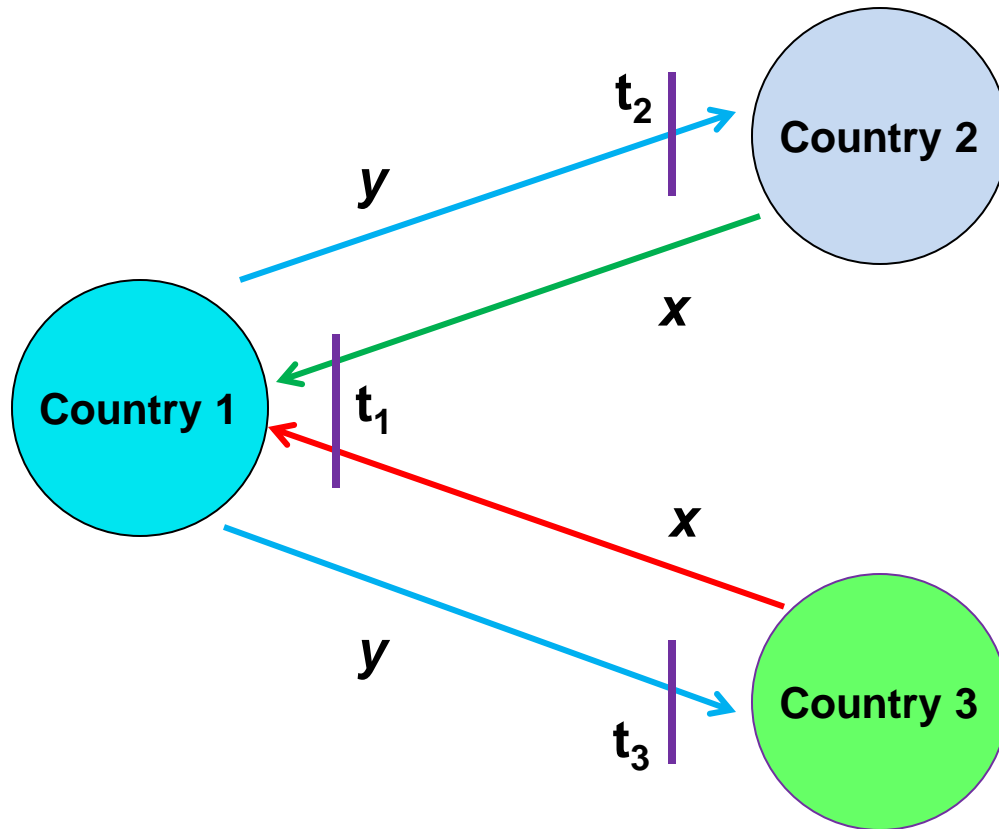
# Pillars of the WTO

- **Terms-of-trade effects translate into negotiation-language: tariffs lead to import volume effects, i.e., loss of *market access***
- **Previous GATT rounds essentially about bilateral exchange of market access via commitment to lower tariffs**
- **Multilateral nature of WTO due to application of most-favored nation (MFN) principle, i.e., bilateral concessions on tariffs offered to all WTO members**
- **In principle, WTO is self-enforcing, i.e., member can retaliate against another if latter unilaterally modifies tariff concession, thereby reducing former's market access**
- **Retaliation may occur if WTO panel finds in favor of harmed member, and offending country fails to offer compensation**

# Developing countries and the WTO

- Developing countries get “free pass” to tariff cuts negotiated in GATT/WTO under MFN clause but do not have to reciprocate, i.e., *special and differential treatment* (SDT)
- Objective to ensure developing countries benefit from gaining market access to developed country markets
- Evidence suggests GATT/WTO membership has resulted in significant increase in trade volumes for developed countries but less so for developing countries (Subramanian and Wei, 2007)
- Bagwell and Staiger (2012) argue that SDT will not deliver benefits of reciprocity – simple maxim for trade negotiations: “what you get is what you give”

# Structure of trade and policies



# Relative prices with tariff-cuts

World prices if  $t_1$  and  $t_2$  are cut:

$$\bar{p}^w = \frac{p_x \uparrow}{p_y \uparrow}$$

Prices in Country 2 if  $t_1$  and  $t_2$  are cut:

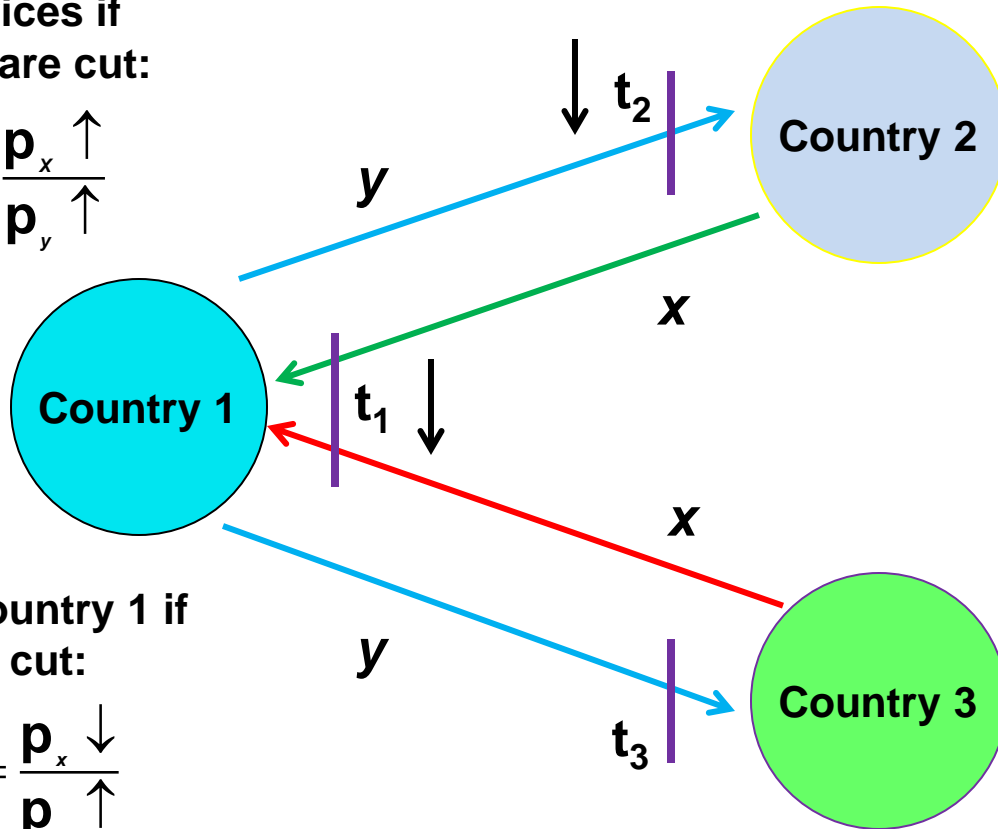
$$\uparrow p^2 = \frac{p_x \uparrow}{p_y \downarrow}$$

Prices in Country 1 if  $t_1$  and  $t_2$  are cut:

$$\downarrow p^1 = \frac{p_x \downarrow}{p_y \uparrow}$$

Prices in Country 3 if  $t_1$  and  $t_2$  are cut:

$$\uparrow p^3 = \frac{p_x \uparrow}{p_y}$$



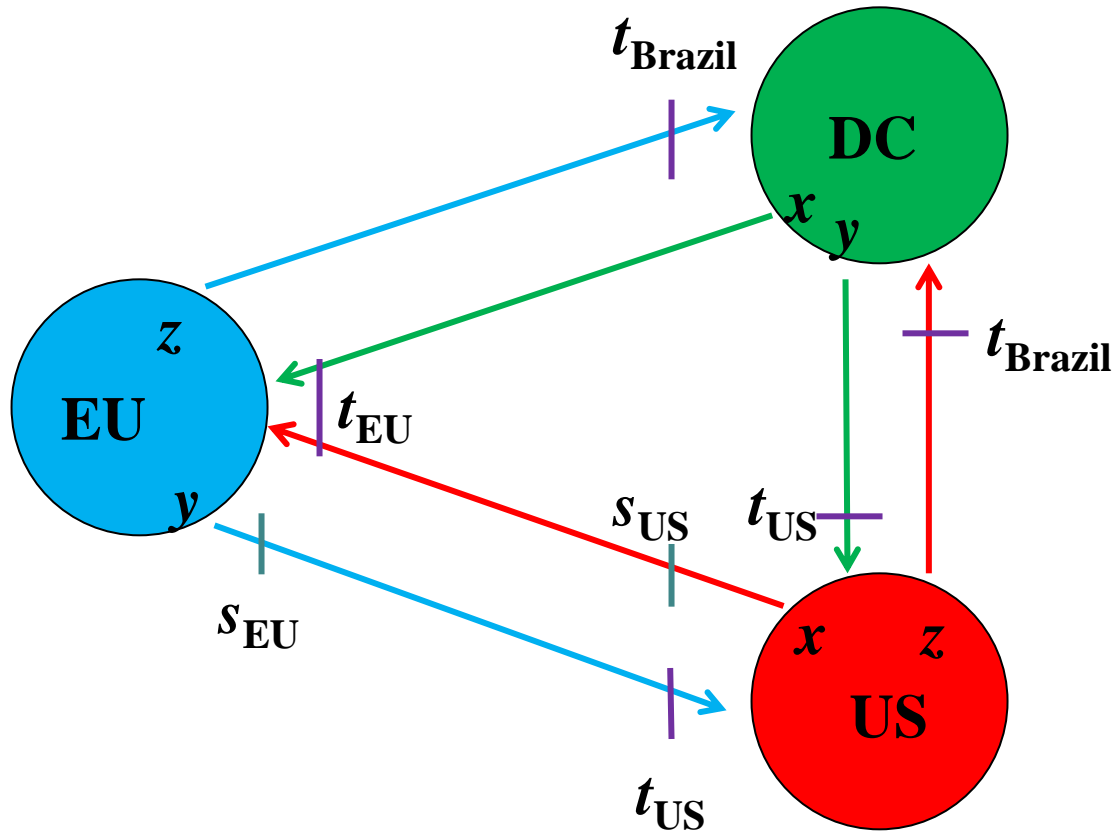
# Is there a “latecomers” problem?

- Even if relaxing SDT pushes Doha Round back towards its original purpose, developing countries may be “latecomers”
- 50 years of reciprocity among developed countries has left tariffs on manufactures very low
- Local price distortions in developed countries already eliminated, making it difficult for them to identify new tariff bargains with developing countries – “globalization fatigue”
- In theory, problem could be solved by developed countries renegotiating tariffs (upward) to make room for tariff negotiations (downward) with developing countries
- Is reduction in farm subsidies key to making “room at the table” for developing countries?

# Farm subsidies and latecomers problem

- **Cut in export subsidies on  $x$  and  $y$  a bargaining chip for US and EU in negotiations with developing countries**
- **Increase in local relative price of say  $x$  in EU places higher value on reciprocal tariff cuts between EU and developing country, EU cutting tariff on  $x$ , and developing country cutting tariff on  $z$**
- **This type of bargain requires relaxation of SDT and clear focus on reciprocal exchange of market access**
- **However – only likely to be effective for large agricultural exporters such as Brazil**
- **Also requires political will in US and EU to reduce farm subsidies**

# Structure of trade and policies





# The rise of offshoring

- Phenomenon of offshoring has seen significant increase in trade in differentiated inputs (Antras and Staiger, 2012)
- In a world where “home” country produces final good using customized inputs supplied by “foreign” country, incomplete contracts may result in a “hold-up” problem
- As a result, input prices determined by *ex post* bargaining as opposed to international market clearing
- Optimal policy choice is free trade in final good and an import subsidy to increase input trade
- Nash policies: home country targets input and final good sectors, while foreign country targets input sector – objective is to extract surplus

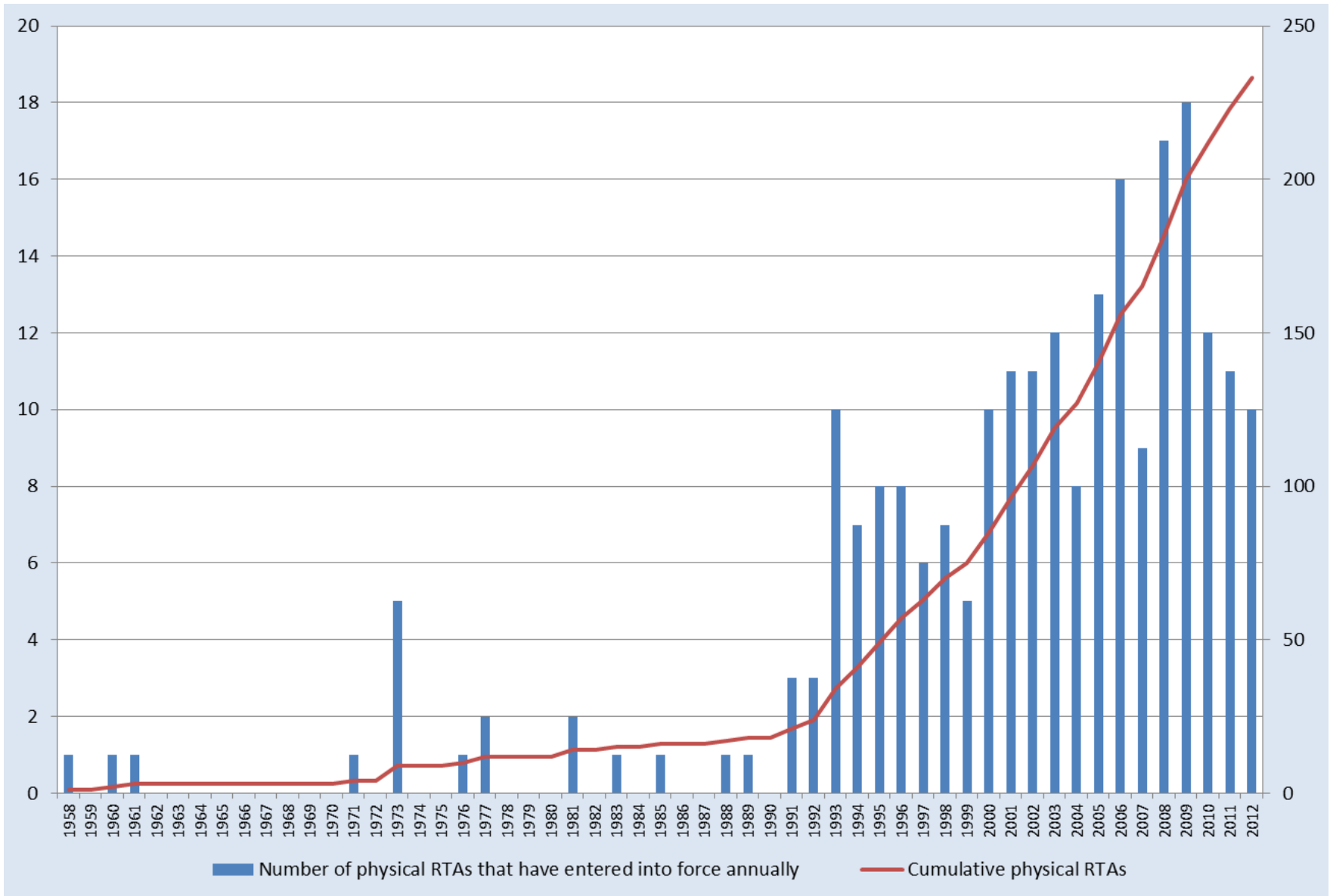
# The WTO and offshoring

- **Emphasis on “shallow integration” via market access may not help in resolving inefficiency that arises in presence of offshoring**
- **In simple set up, “home” and “foreign” countries bargain over policies that affect market access of input, but “home country” will be unconstrained in its use of “behind the border policies”**
- **In presence of offshoring, trade agreement must achieve “deep integration” requiring disciplines on policies beyond market access commitments**
- **This implies shift from rules-based agreement of the WTO towards individualized agreements that take account of idiosyncratic needs of members**

# Proliferation of PTAs

- **Empirical analysis suggests causal relationship runs from offshoring to PTAs (Orefice and Rocha, 2011)**
- **PTAs such as proposed Trans-Atlantic and Trade and Investment Partnership (TTIP) between US and EU are almost exclusively going “behind the border” to focus on aspects such as “regulatory convergence”**
- **Poses significant challenge to WTO – growth in PTAs lies outside its purview, due to GATT Article XXIV allowing exception to principle of non-discrimination**
- **Fear of “concession erosion” may have been replaced by fear of “preference erosion”, and thereby becoming a stumbling block to further MFN tariff reductions (Limão, 2007)**

# Proliferation of PTAs



Source: WTO

# Proliferation of PTAs

- **Baldwin (2006) suggests though that “spaghetti bowl” effect of PTAs may have been somewhat exaggerated**
- **Growth in PTAs involving EU in early-1990s resulted in complex rules-of-origin for inputs across different bilateral country-pairs**
- **Subsequent unbundling of production processes and growth of offshoring by EU-based firms resulted in political pressure to harmonize trade in inputs across PTAs in Europe by 1997**
- **Through simplifying rules of origin, regionalism replaced by multilateralism in input trade within Europe**
- **WTO was a bystander in all of this though, and there is empirical evidence that it hurt export interests of WTO members outside the “club” Augier *et al.* (2007)**

# Whither the WTO?

- **In post-war period, reciprocal exchange of market access has driven significant reduction in manufacturing tariffs and increased trade among developed countries**
- **As successor to GATT, WTO has not delivered a new agreement beyond simplifying customs rules**
- **How to bring developing countries to the table or how to deal with environmental standards, are not the key challenges to the future of WTO as an institution**
- **Desire for “deep integration”, and associated growth in PTAs, does not fit into WTO’s focus on “shallow integration”**
- **WTO still relevant in terms of dispute resolution, but at present it is on the sidelines as countries pursue trade liberalization via regionalism rather than multilateralism**