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Why not in the WTO? The erosion of WTO centricity in trade liberalisation[1]

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Abstract

Little of recent trade liberalization has occurred under the WTO's aegis. Traditional GATT/WTO stalwarts – the EU, US and Japan – pursue market opening goals via North-South FTAs, emerging trade giants are having a worryingly favourable experience with regionalism and unilateralism, and developing nations are autonomously cutting tariffs without binding them in the WTO. This background paper lays out scholarly thinking on why the GATT/WTO was the focal point of trade liberalisation in the 20th century and why this may have changed in the 21st. The paper concludes with points-for-discussion on ways to redress the erosion of WTO centricity.

The Graduate Institute's Thinking Ahead on International Trade (TAIT) programme is a four-year research programme devoted to the analyses of medium-term challenges facing the international trade system in general and the WTO in particular. While founded on scholarship, the analysis is undertaken in association with public and business sector actors. The working method seeks advice and input from the public sector (policymakers, diplomats, international civil servants, and government officials) and the private sector in all matters but especially when it comes to gathering views, prioritising issues and developing action plans to address the challenges identified.

[1] Background paper prepared for Round Table 1: **Why not in the WTO? Liberalisation, rules, and forum choice** at the Inaugural Conference of Thinking Ahead on International Trade (TAIT): **Challenges Facing the World Trade System**, organised by the Centre for Trade and Economic Integration (CTEI) at the Graduate Institute of International and Development Studies, Geneva, in collaboration with the Economic Research and Statistics Division of the Secretariat of the World Trade Organization. Held at the WTO, 17-18 September 2009

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1. Introduction

The new century has seen massive liberalisation of trade in goods and services – much of it by nations that eschewed trade liberalisation for decades. But unlike last century, little of this occurred directly under the WTO's aegis.

- Many developing nations have cut their tariffs, opened their services sectors, and embraced foreign investment either unilaterally, or in bilateral trade agreements; few have made these liberalisations binding in the WTO.
- Many rich nations have relied on regional trade deals to advance market-opening goals in the new century.
- The emerging trade giants have had worryingly favourable experiences with unilateralism and regionalism in the new century while their commitment to multilateralism is relatively untested.

Contrast with the Doha Round's lassitude is striking.

These trends, however, may be less worrying than they seem at face value. The planet's largest bilateral trade flows are still governed by WTO rules rather than RTA rules (intra-EU flows excepted), and the regional deals signed this century cover only modest fractions of world trade. Moreover virtually all of the nations undertaking regional and unilateral liberalisation fully adhere to basic WTO tenets and recognise their value.

Nevertheless, the centre of gravity in global trade liberalisation seems to be shifting away from Geneva. This is one of the challenges the WTO membership must address after the Doha Round is completed.

This paper aims to provide background for a multi-stakeholder discussion on the apparent erosion of WTO centricity in the trade-liberalisation sphere. To set the stage for thinking on what has changed, the paper starts by presenting a synthesis of scholarly thinking on why the GATT/WTO has been so attractive and so successful in the 20th century. We then discuss academic thinking on why nations would want to liberalise outside the WTO (regionally or unilaterally). Finally, we flag a number of issues that might be usefully discussed in a multi-stakeholder setting.

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[2] This is a background paper written for the Round Table "Why not in the WTO? Liberalisation, rules, and forum choice" at the conference "Challenges facing the world trade system," held at the WTO 17-18 September 2009. We thank Manfred Elsig for suggestions and comments, and Pierre-Louis Vezina and Veronika Zvacka for help with the copyediting. .

1 Why do nations cooperate in the WTO?

Most of the world's postwar trade liberalisation occurred under the auspices of the GATT/WTO. Clearly the institution has something going for it, but what exactly makes it an attractive focal point for trade cooperation?

This section presents a conceptual framework to organise thinking on why the GATT/WTO has been such a successful forum for tariff liberalisation. This sets the stage for thinking (in the next section) about why nations seem to be increasingly reluctant to liberalise in the WTO context – liberalising instead regionally and/or unilaterally.

The WTO as a bargain-then-implement institution

The WTO is defined by its rules and its membership. Members agree to follow the rules when implementing trade accords to which they have all agreed. The members periodically negotiate new agreements that deepen and/or widen the existing trade cooperation – knowing that the new agreement will be implemented (and interpreted) according to the rules.

These two elements – negotiation and implementation – are linked using an analytic framework inspired by the work of Stanford professor James Fearon.[3] The framework starts from three premises:

- For many reasons, trade agreements can be advantageous to all parties; this is the heart-and-soul of cooperation in the WTO.
- The number of agreements that are both feasible and mutually advantageous is almost infinite, but they differ in terms of distribution of the mutual gains.
- Bargaining is necessary to determine which of the feasible-and-mutually-advantageous agreement gets signed; this is the heart-and-soul of conflict in the WTO.

Even though the final agreement makes every nation better off, negotiations are conflictual since they concern the distribution of gains. This could be called the "WTO paradox" – strife results from members' efforts to cooperate.

The implications of this "bargain-then-implement" framework are important and subtle. Figure 1 helps systematize the discussion. WTO rules are heart of the institution, so we start with these at the top of the diagram.

The nature and effectiveness of implementation has a big impact on the range of feasible, mutually-advantageous agreements – feasible in the sense that members will find it in their self-interest to honour commitments. The point is simple. A trade agreement cannot be enforced like a domestic contract; there is no international court with international law enforcement powers. Instead, the agreement itself – and the implementation rules governing it – must arrange incentives so that each government prefers to carry out its commitments rather than face the consequences of a transgression. The agreements, in short, must be self-enforcing. This links the implementation structure to the set of feasible agreements (arrow number 1). Thinking about the details of the linkage is instructive.

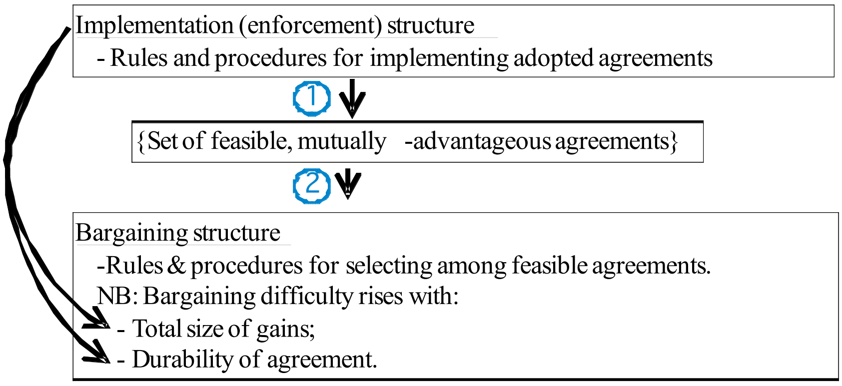
When global trade and investment regimes are very open, small distortions can have large effects on the location of production, on jobs, and on trade flows.[4] Thus incentives for

[3] Fearon (1998) but also drawing on Olsen (1965), and Keohane (1984).

[4] In economics, Krugman (1980) identified this effect as the 'home market magnification effect'; production, he showed, get more footloose, not less, as trade gets freer. See Ossa (2009) for application to WTO negotiations.

opportunistic behaviour tend to increase with the depth and breadth of trade liberalisation. In short, deeper integration requires more effective "enforcement". Turning this around and assuming nations only agree to liberalisations they believe will be implemented, a stronger WTO implementation mechanism opens the door to deeper cooperation. This is the arrow-1 link.

Figure 1: The "bargain-then-implement" framework



The chain of causality does not end here. The nature of feasible cooperation affects the nature of the bargaining (arrow number 2). Deeper trade cooperation (enabled by a better implementation) increases the size of the mutual gains from cooperation. But a bigger pie means nations are willing to bargain harder – to engage in a longer 'war of attrition' – to win a larger share. This creates a link between the implementation mechanism and the difficulty of the bargaining (left arrows in the diagram). Roughly speaking, concluding fresh negotiations gets harder as the WTO becomes a more effective enforcement mechanism. This is a corollary of the WTO paradox; the deeper and more durable is the cooperation, the more intense is the strife over deepening cooperation.

The reasoning behind the need for organising trade liberalisation in this sort of bargain-then-implement structure does not address the question: "why in the multilateral setting (as opposed to bilateral or plurilateral)?" Before turning to this question below, we highlight a few important features of the WTO's implementation and bargaining mechanisms.

1.1 WTO implementation and bargaining mechanisms

Once an agreement is signed, nations usually face the temptation to renege on some commitments – even though they signed an agreement and will benefit from it. Or more subtly, governments face pressure from particular domestic groups to back off on some of the commitments. This creates a collective action problem for the community of trading nations. The implementation mechanism of the WTO is part of the solution to this collective action problem.

The WTO's role in surveillance, enforcement and adjudication are crucial in avoiding opportunistic behaviour by members. Several of the key WTO principles also help with implementation. A good example is the reciprocity principle which authorises measured, non-MFN retaliation in cases of certified transgressions, thus helping to avoid transgressions in the first place. Or, more subtly, the likelihood of retaliation helps governments refuse certain policies to powerful special interest groups. The procedure for certifying transgression also reduces the chance that any single transgression will have an outsized impact on trade cooperation (one example being the concerned nation withdrawing from the WTO). The WTO's rules on countervailing duties similarly help governments resist pressures to offset the domestic pain of tariff liberalisation with production or export subsidies.

The WTO principle of including escape clauses also helps sustain cooperation in a more ingenious way. Such clauses provide governments with a disciplined, temporary way of reneging on specific commitments when they find themselves under irresistible domestic pressure. This gives them a way of continuing most trade cooperation even when facing ineluctable pressure to renege on some commitments.

Finally, the value of the WTO system is itself a powerful force for implementation. All WTO members realise the massive benefits the world enjoys thanks to the WTO's rules and the bound tariff liberalisation. Living memory of the 1930s trade debacle may be fading, but sitting governments are keenly aware that the favourable state of trade cooperation cannot be taken for granted. Members are aware that sufficiently bad behaviour (recidivist violation of WTO norms, repeated and widespread reneging on commitments, systematic scofflaw behaviour, etc.) could bring down the whole system – an unhappy state of affairs where everyone would ignore the norms since they expected everyone else to do so. Fear of this 'trade Armageddon' grows in proportion to a nation's dependence on trade, so it has an especially powerful influence on the world's trade hegemons.

When thinking about the WTO's bargain mechanism, it is crucial to keep in mind the complexity of a modern multilateral trade negotiation (MTN). The last one (Uruguay Round) was almost unimaginably complex; it produced an agreement that filled more than 25,000 pages. Given this complexity, and the fact that no WTO member can be thought of as a disinterested fair broker, the WTO's elaborate negotiation procedures are essential for the success of MTNs. These procedures include agenda setting, committee chair selection, sequencing negotiations by area, and much more. As is the case with implementation, the perception that the WTO is a fair broker is crucial to its role as a facilitator of bargaining. The WTO negotiating principles – especially reciprocity, transparency, and MFN – also play a key role in reducing bargaining/transaction costs. (See Elsig 2009 for a more detailed analysis and critique of the bargaining mechanism.)

1.2 Why multilaterally?

This rather abstract framework helps organize thinking on the linkages between negotiation and implementation. It helps us understand why most trade agreements are done in the context of some form of institutional arrangement. The framework does not, however, explain the manifest attractiveness of the GATT/WTO as a forum for trade liberalisation in the postwar period. It does not answer the question: Why multilaterally rather than bilaterally or plurilaterally?

Five main arguments for the superiority of liberalising multilaterally are worth mentioning in this brief review of scholarly thinking (see Warwick Commission 2007 for related views).

The practicality of multilateral balancing of market-access exchanges. The first argument is practical, concerns tariff cutting, and works off the premise that nations traditionally found it easier to liberalise in the context of a balanced exchange-of-market-access. To see the point, consider the first GATT Round, the 1947 Geneva Round. The negotiations were conducted on the so-called principal-supplier method which meant all bargaining was bilateral and product-specific. Despite the restrained number of negotiating nations, and despite the much narrower range of traded good in 1947, the agreement was massively complex; about 45,000 bilateral, product-specific tariff cuts were agreed. Under the MFN principle, these bilateral tariff concessions where extended automatically to all GATT members. The deal was struck comparatively rapidly, at least in part because it was fairly easy for nations to work out the balance of concessions implied by the overall deal.

The merits of multilateralism become clear when one tries to imagine what these talks would have looked like without the GATT, i.e. done bilaterally with each nation seeking balance tariff concessions bilaterally and sequentially. This alternative bargain structure would engender two sets of serious problems.

- As the value of each bilateral tariff concession depends upon the concessions extended to third parties, each subsequent bilateral agreement would undermine the balance of all the previous deals; each new bilateral would require a renegotiation of all agreements, triggering a potentially ceaseless loop of negotiation and renegotiation.

Worse yet, in anticipation of the possibility that earlier deals might not be rebalanced, nations would hesitate to agree on a bilateral exchange of concessions in the first place.

This is essentially a coordination problem and multilateralism is the obvious solution (specifically, simultaneous bargaining under the MFN principle). In this view, multilateral liberalisation is just a more practical way of organising the exchange of market access among many nations on many products. Indeed, up to the mid-1980s, almost all tariff-cutting was done in the context of multilateral trade rounds (with the important exception of intra-European trade liberalisation).

- Bilateralism greatly restricts the range of exchange-of-concessions.

There is a perfect analogy with the shortcomings of a barter economy. Writing in an era when economists were vastly more readable, Jevons (1893) explained: "The first difficulty in barter is to find two persons whose disposable possessions mutually suit each other's wants. There may be many people wanting, and many possessing those things wanted; but to allow of an act of barter there must be a double coincidence, which will rarely happen." In the same manner as money facilitates the multilateral exchange of goods, the GATT/WTO opens up a vastly broader set of self-balancing market-access exchanges. Notably, this broader set includes much deeper tariff cuts and in this way multilateralism fosters mutually advantageous trade liberalisation.

Network externalities and the rule of law. The second advantage of multilateralism involves the WTO's rules and turns on fact that the 'rule of law' is subject to "network externalities", i.e. the value of a set of rules to each nation rises with the number of nations using the rules. In such a situation, every nation can be better off when they all use the same rules (very much like computer operating systems, DVD recording standards, etc.).

Trade agreements require rules and mechanisms to incentivise compliance and facilitate interpretation in the light of unforeseen events. If global trade liberalisation were conducted entirely bilaterally, the result would be a tangle of rules and implementation mechanisms – dispute settlement procedures, definitions of 'like products' and subsidies, permissible dumping and safeguards procedures, etc. This would be highly inefficient and hinder all sorts of welfare-boosting trade and investment. There is an exact analogy with rules of the road. Nations either drive on the left side, or they drive on the right side. One can argue about which is superior, but the benefits of having a single rule in each nation is obvious. This is a coordination problem; nations around the world find multilateralism attractive as it helped them coordinate on a single set of "rules of the road."

Interestingly, this aspect is most important to nations with the most complex trade patterns. A nation like Mexico sells most of its exports to a single nation (the US). A global fragmentation of rules would only modestly hinder its exporters. A nation like Japan, by contrast, does business in over 100 countries. For Japanese exporters, the global coherence of trade rules provides huge benefits.

Tying the hands of special interest groups in the hegemons. The third advantage is closely related to the previous and concerns power asymmetries. Today, trade is highly concentrated in the hands of three big trade powers – the EU, the US, and Japan – although less so now than it was before the emergence of emerging economies. Left to their own devices – i.e. in the absence of multilateralism – powerful special interest groups in these hegemons would surely have pushed their governments to establish separate, GATT-like rules and structures for negotiating and implementing trade agreements. Various special interest groups in the various hegemon would ensure that their own rules were warped in idiosyncratic directions. This sort of "Great Powers" world would have almost surely resulted in a fragmented trade system; trade and investment in this antimonde would be significantly hindered for all nations, but especially for the big trade powers with their globe-spanning trade and investment patterns.

In this light, multilateralism is a way for the trade giants to avoid endless bargaining over the details of trade rules. Or, more subtly, it is a way for the big hegemons to constrain opportunistic behaviour by power domestic pressure groups by pitting them against similarly powerful foreign special interests. Note that small trade powers would, with our without multilateralism, be compelled by the logic of commercial relations to accept rules formulated by the hegemons. In this sense, multilateralism is a way of facilitating cooperation among hegemons (although of course all benefit via network externalities from having a single, global set of norms).

Scale economies in transaction and information costs. The fourth advantage concerns scale economies in transaction costs and information costs. Many of the difficulties faced by nations who cooperate on trade can be traced to information problems, and transaction (bargaining) costs. In a multilateral trade system, bargaining, information gathering and dissemination are done centrally. Since there are economies of scale to such activities, cooperating multilaterally has an intrinsic advantage over the counterfactual of purely bilateral cooperation.

Guarding the guards. The fifth problem concerns the old conundrum: "who shall guard the guards?" Information problems are frequently at the heart of trade conflicts. While many of these conflicts are true bargaining problems – where the question is essentially how to divide the pie – some of the conflicts arise due to misunderstandings, or lack of trust in information provided directly by governments. Mediation, facilitation and arbitration by a trusted third party can go a long way to resolving or avoiding conflicts. Just as an outsider can help resolve bitter disputes among firms or between firms and labour unions, the WTO reduces conflict by acting as a 'fair broker.'

But why should the fair broker be a multilateral institution like the WTO? One could imagine a world where there were many of these fair brokers. Trust is a key element in being a successful fair broker. Trust, however, creates its own network externalities, or virtuous cycle. The GATT/WTO has built up such trust over decades, so conflicts are frequently brought to the WTO. As more conflicts get resolved in the GATT/WTO the trust gets stronger, thereby making it even more the forum-of-choice for settling conflicts.

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On this point, it is particularly important that the WTO dilutes the individual power of trade hegemons. To see this, imagine what would have happened if instead of the GATT/WTO, the postwar trade hegemons had each set up their own 'fair broker' conflict resolution mechanisms. Plainly these would be flawed-from-birth on the trust issue by their close association with a single trade hegemon.

A discussion of the many other advantages of multilateralism discussed in the scholarly literature can be found in WTO (2007).

Why cooperate on trade?

To better understand why nations are increasingly undertaking their liberalisation outside of the WTO system, it is important to think carefully about why nations sign trade agreements at all. While the full answer would fill a library, we cut it short by summarising the abstractions posited by scholars, drawing heavily on the WTO's own masterful synthesis of this literature (WTO 2007).

Most scholars approach this question from the baseline of the market and unilateralism; nations cooperate to solve problems that cannot be solved by the market or by unilateral policy action. There are two categories of such problems: external and internal.

Solving nation-to-nation problems[5]

One branch of the thinking focuses on external problems – i.e. nation-to-nation problems. Here trade agreements are the solution to an international collective action problem. There is a close analogy to people's view of traffic lights; everyone agrees that life with traffic lights is better than life without them, but many people would drive through red lights if there were no traffic laws. Trade agreements, like traffic laws, are a way of getting everyone to respect the mutually-beneficial cooperative outcome.

More formally, the prisoners' dilemma is used to organise this thinking (often called the terms-of-trade approach). For example, nations may prefer to keep their tariffs high while others cut theirs, but they prefer the all-liberalise to the all-protect outcome. This combination of desiderata creates a "prisoners' dilemma externality" that trade agreements can solve (see Box 1 at the end of the paper). The second branch focuses on internal problems rather than external problems.

Solving internal political problems[6]

In this line of thinking, the key to reciprocal trade agreements is the way they affect domestic politics. Trade agreements induce nations' exporters to oppose their own nation's trade barriers even though exporters are not directly concerned by them. The reason for such behaviour is that reciprocity in trade agreements connects lobbying against domestic protection to foreign protection; foreign barriers fall if and only if domestic barriers fall. This alters domestic political coalitions – switching exporters from bystanders to pro-liberalisers. The resulting realignment in special interest groups inside each nation can allow each government to put together a winning coalition for tariff liberalisation – something they could not have done without the political support of the exporters. Trade agreements, in short, are devices for harnessing the political power of domestic exporters to the work of improving the

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[5] See Krugman (1991), and Bagwell and Staiger (1999, 2002).

[6] See Robert Baldwin (1987, Destler (1992), Magelby and Nelson (1990), Snyder (1990), Richard Baldwin (1990), Baldwin and Baldwin (1996), and Grossman and Helpman (1995). On commitment, see Maggi and Clare-Rodrigues (1998).

nation's wellbeing – specifically, to overcome the disproportionate political power of protectionist special interest groups. In this view, the key to trade agreements is the way they help governments solve an internal political-economy problem.

A very different set of internal problems concerns governments' credibility, or more precisely, the lack of it. For example, the Mexican government abandoned its longstanding protectionist stance in the 1980s and unilaterally cut tariffs. This was politically optimal for the sitting government, however it suspected that special interests would, in the future, force future Mexican governments to reverse the reform. To counter this lack of long-run credibility, the sitting Mexican government decided to join the GATT and bind the tariff cuts. Since raising bound tariffs would attract foreign retaliation, the "trade agreement" (GATT membership in this case) raised the cost of future policy reversals enough to make the tariff cuts credible over the long run. In short, trade agreements are commitment devices.

Legal theory views. The view of trade agreements as solutions to external and internal externalities is a view embraced by most international economists and international relations scholars.[7] International trade lawyers tend to have a different view. The legal theory approach to trade agreements is akin to the commitment device approach but focuses on individual citizens. Basic legal theory views the rule-of-law as a defence for citizens against arbitrary governance. In this light, trade agreements can be viewed as devices to tie the hands of a citizen's own government or those of foreign governments – thus strengthen the defence.

Neorealism and constructivism. A very different reasoning is advanced in international relations under the name neorealism. Neorealist thinkers take as given that the underlying premise for trade agreements is the solution of a collective action problem that enables gains for all nations. However, these thinkers assert that the key issue is relative gains, not absolute gains. This approach, which is more widely used in other aspects of international relations (e.g. security studies), spreads its wings far beyond simple trade deals. International economic relations of all types, including trade cooperation, raise the issue of relative power that eventually gets translated into military capability which in turn can threaten the existence of states. What matters for the really big concerns (national security and state survival) is relative power and this is affected by relative gains. Countries often stand back from efficiency-enhancing cooperation when they suspect that it may grant greater gains to other nations. In the extreme, neorealism views trade agreements as one way through which nations seek to squeeze other nations and thus elevate their international power ranking.

Constructivism rejects that whole view of nations as rational decision makers. Nations cooperate in the WTO since that is the right thing to do according to prevailing norms. An important aspect of this is the way that cooperative behaviours feedback into the norms that support them.

2 Why nations liberalise outside the WTO

This section lists some of the reasons nations liberalise in RTAs or unilaterally. The list is drawn from information interviews and informal discussions with policy makers as well as press accounts and policy research on particular agreements.

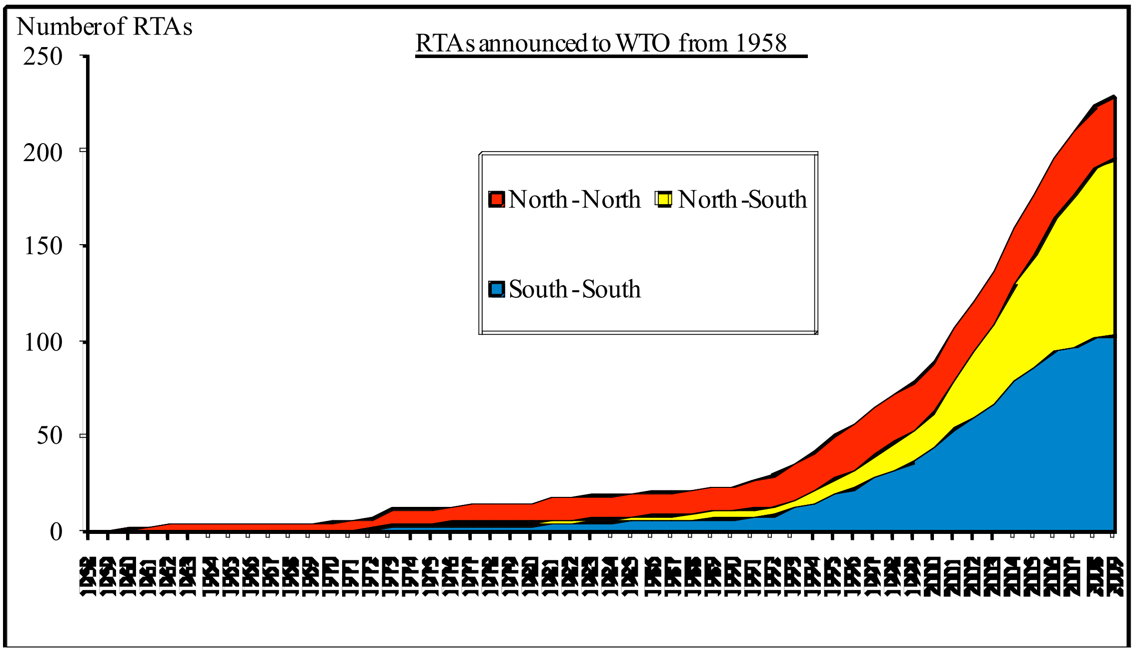
Why regionally rather than multilaterally?

Signing bilateral and plurilateral trade agreements is all the rage (Figure 2), even if the growth rate seems to have slowed in the last few years. This popularity of RTAs clearly

[7] See Keohane (1994).

demonstrates that nations are interested in signing trade liberalising agreements. But why do nations choose the exchange market access in the narrow confines of an RTA rather than multilaterally? We can lump the various reasons into three categories: RTAs are easier and more flexible, RTAs are safer, and RTAs bring benefits the WTO cannot provide.

Figure 2: The boom in RTAs



Easier and more flexible. The WTO negotiations are slow and cumbersome. RTAs are often much easier and some can be signed much faster. One key aspect of this is the flexibility inherent in bargaining among a small number of nations. This is especially marked in the case of South-South RTAs. Under the Enabling Clause, most of the WTO's disciplines on RTAs are disabled (e.g. Article 24 strictures). Even when it comes to developed nations, the RTA route can allow nations the flexibility to negotiate derogations for special sectors, or win deeper market access for a particular set of export interests.

Less uncertainty, or "safer". The "single undertaking" principle – combined with the WTO's Dispute Settlement Mechanism (DSM) – may make nations think twice before committing to liberalisation in the multilateral system. If unforeseen circumstances arise and it becomes imperative for a member to renounce certain commitments, DSM sanctioned retaliation may harm powerful interest groups making the original commitments expensive politically. Undertaking the same commitments in RTAs is "safer" since it is easier to renegotiate commitments bilaterally.

A second aspect of the 'safer' point concerns the value of concessions received and extended. This point applies especially to Behind the Border Barriers (BBBs), such as the regulation of service sectors and restrictions on government procurement. When it comes to complicated issues like trade in services, the state of economic understanding does not allow nations to clearly calculate the commercial implication of, say, the removal of a particular banking-sector BBB. This is a particularly difficult problem to the extent that nations seek balanced exchange of market access. When nations cannot predict with confidence exactly which exporting nations will benefit (and by how much) from a particular liberalisation commitment, it is difficult or impossible to use the concession as leverage to win a matching concession. With over a hundred WTO members – at least a dozen of which have highly competitive service sectors – it may be impossible to identify winners and losers with the precision needed to balance the market-access-exchange package. The problem does not disappear in a bilateral setting, but at least the demandeur can usually be identified with certainty.

Other gains. RTAs can provide a range of non-economic benefits that are unavailable in the WTO. Things such as security guarantees and regional confidence-building are not on offer in WTO agreements. A separate source of gains can come from the more detailed discipline involved in some RTAs, and bilateral investment treaties (BITs), especially in a North-South relationship. Such RTAs and BITs routinely include commitments that go beyond disciplines in the current WTO agreements and often beyond the commitments that are likely to emerge in the eventual Doha Round agreement.[8] For some nations, this "governance backbone" may be welcome on its own. For others, it is a means for attracting FDI and supply-chain jobs from the main developed country partner. The WTO does not offer credible bindings on the broad range of policies necessary to attract FDI.

Domino effects. A common explanation for the rush of RTAs is that everyone else is doing it. When a nation's main trade partners start signing RTAs among themselves, the nation may feel compelled to react by signing its own RTAs. The new RTAs make it even more important for other nations to sign RTAs. In essence, the trade diversion from the first RTAs knocks down trade barriers like a row of dominos. This is clearly not an independent, systematic explanation for why nations seem so eager to liberalise regionally. Domino effects merely amplify the underlying trend.

Why unilaterally rather than multilaterally?

Since the mid-1980s, many nations – chiefly developing nations in East Asia and Latin America – have unilaterally reduced tariffs in an important way (Table 1) but baulk at the idea of binding these in the Doha Round. What has changed that makes unilateral liberalisation – one of the longest-ignored tenets of economics – so popular in recent decades? And if nations do find it politically optimal to lower tariffs autonomously, why are they unwilling to lock in these reforms in the WTO?

Looking at the pattern of unilateralism reveals a clear bias towards tariff reductions in parts and components (e.g. in electrical and mechanical machinery). One explanation for this is based on the changed nature of trade – a change that started in the mid-1980s at about the same time that unilateralism started to pick up. The emergence of international supply chains is the key change in this view (Baldwin 2006). The shift has played a key role in the rapid industrialisation of many developing nations – many of the same nations that have cut tariffs quickest and furthest. Unilateralism is also boosted by a sort of 'race to the bottom' in the competition for offshored manufactured jobs from the most technologically advanced nations, for example Japan, the US, and Germany.

There are three strands of this supply-chain-race-to-the-bottom theory of unilateralism. The first is that the unbundling of the production process has resulted in goods trade for which there is often no import-competing firms. If Thailand, for example, imports an advanced Japanese gearbox to be assembled into a Toyota automobile platform which is then exported, the import gearbox generates little domestic opposition; there are no import-competing firms. The second addresses the possible domestic political economy externality. Since many such imports are re-exported after having been assembled with other parts, the importing and

[8] For an overview of bilateral deals' impact on FDI, see Sachs and Sauvant (2009).

exporting is often organised by the same firm. As such, the traditional indifference of exporters to domestic import barriers melts away. The domestic political economy problem that trade agreements used to help governments solve disappears and with it the need for reciprocal trade agreements as a liberalising device. In short, governments do not need a reciprocal trade agreement to turn the exporters from bystanders to free traders when it comes to imported parts and components.

Table 1: Multilateral and unilateral liberalisers (MFN non-agricultural tariffs, %)

	Bound	**Applied**	**Unilateralism Index (Bound - Applied)**
		Multilateral liberalisers	
Japan	3	3	0
US	3	3	0
China	9	9	0
EU	4	4	0
Taipei, China	5	5	0
Switzerland	3	2	0
Canada	5	4	1
Korea	10	7	4
		Unilateral liberalisers	
Indonesia	36	7	29
India	36	12	25
India	36	12	25
Mexico	35	11	24
Argentina	32	12	20
Brazil	31	13	18
Philippines	23	6	18
Thailand	26	8	17
South Africa	16	8	8
Australia	11	4	7
Malaysia	15	8	7

Source: WTO Tariff Profiles, 2008 & authors' calculations.

The third strand of the argument concerns competition among developing nations for offshored jobs. Offshored manufacture jobs from technologically advanced nations provide large gains for the developing nations receiving such jobs. Since removing tariffs makes export-processing activities (trade and investment) easier and more profitable for the offshoring company, companies asked for such tariff cuts. As there were many nations competing for such investments, it was difficult for any individual nation to resist call for unilateral tariff liberalisation.

Notice that this unilateralism is not fully autonomous; there is an implicit cooperation or shadow agreement. The developing nation lowers its trade barriers in exchange for FDI that creates industrial jobs. Importantly, there is no particular need for a commitment device such as a tariff binding. Once the new factory is built, the domestic government does not gain from re-raising the tariffs as this would harm the newly created special interest group. After all, raising tariffs on inputs <u>reduces</u> the effective rate of protection on the downstream activity.

Are regionalism and unilateralism really alternatives?

Before suggesting a list of points for discussion, we briefly discuss ideas that suggest RTAs will help rather than hinder multilateralism.

There are at least two important ways in which RTAs could eventually make it easier for nations to liberalise in the WTO. The first is the juggernaut logic that works on the way that most forms of reciprocal trade liberalisations tend to strengthen pro-trade political economy forces (mainly exporters) and tend to weaken anti-trade forces (import competing sectors). According to this analysis, RTAs could, by altering the relative power of domestic pressure, make it easier to for governments to assemble a coalition for multilateral liberalisation.

The second is based on the idea that RTAs can play a 'pioneer role', namely can help explore the ease and efficacy of various liberalisation modalities when it comes to Behind the Border Barriers (BBBs), especially in the area of services trade.

3 Points for discussion

This paper aims to provide a background for a discussion of the issues by thinkers from the academic, diplomatic and business worlds. This final section lists a number of questions that may deserve attention in the discussion.

1. **Has WTO centricity been eroded as far as trade liberalisation is concerned?**

One the one hand, the explosion of RTAs suggests the answer is 'yes', but most of these cover only modest shares of trade. The big RTAs (EU, NAFTA, Mercosur, ASEAN, SACU, etc) are not new. On the other hand, the perception that many WTO members, including the big players, seem to be pursuing RTAs with more vigour than multilateralism is evidence of the erosion of WTO centricity.

The massive unilateral liberalisation by developing nations covers a more important share of global trade, but does unilateralism pose a threat to the WTO as a trade liberalisation forum? On one hand, the GATT/WTO binding concept was designed precisely to allow this. On the other hand, the reluctance of members to give credit for binding unilateral tariff-cutting (since such bindings grant exporters no new market access and thus don't help to balance fresh concessions) suggests that unilateralism has reduced the scope for mutually advantageous exchanges of tariff cuts.

2. **Is today's system of trade agreements – a tangle of RTAs loosely orchestrated by WTO principles – sustainable? Maybe even optimal? Or is this the start of a slippery slope on the way to a breakdown of multilateral trade cooperation?**

One on hand, it is absolutely clear that global respect for basic WTO principles has played an important role in ensuring that regionalism has not been conflictual as it was in the 1930s. Moreover, as the GATT/WTO process had already lowered MFN tariffs on the world's major trade flows to fairly low levels, the discriminatory content of the recent RTAs is typically fairly modest with obvious exception – most of which apply to fairly small trade flows (the EU's CAP being the most significant exception). In this building-bloc view, the eventual MFN elimination of tariffs may come to be a "why not?" proposition.

On the other hand, the proliferation of RTAs has been accompanied by a proliferation of 'rules of the road' on BBBs and implementation/dispute settlement mechanism. This clearly undermines the WTO's greatest achievement, namely the establishment of a near universal set of norms in the area of international trade. Moreover, the shift in the locus of trade liberalisation seems more like a challenge to the WTO than a threat. The key players seem to believe the world trade system will continue to be anchored by the WTO's shared values, such as reciprocity, transparency, non-discrimination, and the rule of law; each member views its own policies as minor derogations. Yet, at some point derogations become the new norm. The pessimistic view suggests that steady erosion of the WTO's centricity will sooner or later bring the world to a tipping point – a point beyond which expectations become unmoored and nations feel justified in ignoring WTO norms since everyone else does.

3. **Should the WTO be reformed to bring more liberalisation back into the multilateral system?**

Such reforms would be contentious and there is always the possibility that any reform that made it easier to liberalise in the WTO's multilateral framework – e.g. variable geometry – had the unintended effect of undermining the multilateral disciplines and universality of norms that has made the WTO such an important element of postwar prosperity.

4. **If reform is a good idea, which reforms would enhance the WTO's attractiveness as a centre for new trade cooperation?**

The reasons nations give for signing RTAs is a good place to start looking for ideas on shoring up the WTO's centricity in global trade liberalisation. Some of the reasons are in fact a critique of the WTO's heart-and-soul – its implementation mechanism, including the DSM. It would surely be throwing out the baby with the bathwater to suggest this be dismantled. As our analytic framework suggested, an effective implementation mechanism is critical to maintaining the impressive trade liberalisation that occurred in the GATT/WTO in the 20th century. But there may be ways of facilitating agreements under the WTO's auspices without undermining the core achievements.

4 Concluding remarks

While the attention of national leaders has rightly been focused on concluding the Doha Round, it is important to debate causes, consequences and cures of erosion of WTO centricity in the area of trade liberalisation. It is important to "think big" on these issues; a major rearrangement of long standing practices may be necessary to protect the coherence of the world trade system. The GATT/WTO was designed to eliminate tariff primarily among rich nations. The membership and liberalisation agenda has shifted radically since then; maybe the WTO needs to shift in response. In the past, the GATT/WTO survived and flourished by adapting to new realities. Maybe the time has come for another major revision of WTO's highly successful bargain-then-implement framework.

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3. Box 1: Trade agreements and the prisoner's dilemma

The prisoner's dilemma is the classic thought-experiment that illustrates why cooperation may be both difficult and desirable. A version of the argument – highly stylised for the sake of intellectual clarity – can be seen in Figure 3.

In the figure, two choices ('protect' or 'liberalise.') face two governments (Nation A and Nation B). There are four possible outcomes: both protect, neither protects, and only one protects (either A or B); these are shown by the four boxes. The governments of nation A and B evaluate the four possible outcomes; we simplify the results of these evaluations to numbers (which could represent, for example, national welfare measured in billions of dollar but the actual number is not important, what matters is the relative ranking).

In the example at hand, the southeast box shows the both-liberalise outcome where they both earn 3 (we assume nations are symmetric for simplicity's sake). If Nation A liberalises while B protects in this example (southwest box), A's welfare falls to 1 while B's rises to 4. The idea is that firms in B would react to A's liberalisation partly by exporting more and partly by charging a higher price. Nation B gains from both the higher exports and prices; Nation A gains from the increased trade flow, but suffers from the higher prices. (The fact that the price change is good for one and bad for the other is called the 'terms-of-trade' externality.) Depending upon height of the original tariff, Nation A may win or lose, but in the example, Nation A is made worse off by its unilateral tariff cutting. The reverse policy combination (northeast box) is good for A but bad for B compared to the situation where both liberalise.

Figure 3: Prisoners' dilemma

Nation B's choices:

Nation A's choices:	*Protect*		*Liberalise*	
	A's welfare	B's welfare	A's welfare	B's welfare
Protect	2	2	4	1
	A's welfare	B's welfare	A's welfare	B's welfare
Liberalise	1	4	3	3

The last possibility is that both protect (northwest box) and here both are worse off than in the both-liberal-box (southeast).

This is a collective action problem; unless they can coordinate policies internationally, they will be stuck at the inefficient northwest box where both protect and both are worse off as a result. The reasoning is simple. If they start off at the both-protect box, neither nation would find it optimal to liberalise – due to the 'terms of trade' externality. Even if they start off cooperating (the southeast box), they need something to coordinate policies each has a unilateral incentive to protect; either would gain from unilaterally from raising barriers. Since this holds for both nations, the situation tends to slip back into the 'bad' non-cooperative outcome (northwest box).

In the terms of trade approach, the role of a trade agreement is to ensure nations end up in the southeast/cooperation box rather than the northwest/non-cooperation box.