

Termites **in the Basement**

To free up trade,
fix the WTO's foundations

Andrew Stoeckel

TERMITES IN THE BASEMENT

**To free up trade, fix the
WTO's foundations**

Prepared by
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Prepared for
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Development Corporation**

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FOREWORD

Barriers to agricultural trade cost Australian farmers dearly. Through a combination of border restrictions, domestic support and export subsidies that have proved hard to remove, foreign governments have left agriculture one of the most protected sectors in the world today.

The principal way Australia and the world has grappled with reducing these barriers and lifting prosperity has been to conduct successive 'rounds' of multilateral trade talks. The last round of trade talks — the Uruguay Round — while not achieving much by way of actual liberalisation, at least put agriculture formally on the world trade agenda and established a framework for subsequent reductions in agricultural subsidies and barriers to trade. The current round of trade talks — officially called the Doha Development — has proved slow going. The meeting of trade ministers in Cancun late last year broke up without agreement on going forward. There is, as yet, no political consensus to free up world agricultural trade.

This study, commissioned by the Rural Industries Research and Development Corporation (RIRDC), suggests there are some deep-seated problems with the world trading system. It highlights where part of the problem lies and what may be done about it to supplement Australia's negotiating positions, which are advanced through chairing the Cairns Group of agricultural exporting countries.

FOREWORD

The lack of political consensus to free up agricultural (and other) trade comes from muddled thinking and confusion about the benefits of liberalising trade. This confusion, in turn, comes from the inconsistent (and sometimes flawed) rules of the world trading system administered by the World Trade Organization (WTO) and from the economic flaw embodied in the politically popular negotiations process itself.

The main remedy involves two changes to the ongoing regular reviews of the trade policies of WTO member countries: a natural progression to better economic governance; and measuring economy-wide economic costs and benefits through open, independent processes. Since these will take time, nine other worthwhile steps to do in the meantime are suggested to move the trade liberalisation debate along.

Hopefully, countries will act on these ideas since the payoff to the world as well as Australia is potentially enormous.

A handwritten signature in black ink, appearing to read 'Simon Hearn', written in a cursive style.

Simon Hearn
Managing Director
Rural Industries Research and Development Corporation

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ACKNOWLEDGEMENTS

The idea for the title of this book came from a subheading of a chapter in a book by Sylvia Ostry¹, *The Post-Cold War Trading System*, published in 1997. It captured well the essence of the message I wanted to convey — that the foundations of the world trading system administered by the World Trade Organization (WTO) were being slowly eroded by some flaws in the institutional rules. Unless these are fixed the WTO trading system will not be on a secure footing to do the job it is meant to do: promote an open non-discriminatory system of world trade that would enhance growth and prosperity.

Helpful comments were received from Will Martin of the World Bank, Ben Fargher from Australia's National Farmers' Federation, Alan McKinnon from the Australian Department of Foreign Affairs and Trade and Hugh Corbet from the Cordell Hull Institution in Washington DC. Remaining errors and admissions are, of course, mine alone.

Editorial input was provided by Kate Stewart and Kate Stoeckel and Anna Bieler oversaw production and publication of the study. Their input is gratefully acknowledged. Finally, the financial support of the Rural Industries Research and Development Corporation is also gratefully acknowledged.

¹ Ostry, S. 1997, *The Post-Cold War Trading System: Who's on First?*, A Twentieth Century Fund Book, University of Chicago Press, Chicago.

SUMMARY

The institutional arrangements of the multilateral trading system are full of inconsistencies, loopholes and flawed rules. On top of that, the mercantilistic 'exports good, imports bad' philosophy underlying successive 'rounds' of multilateral negotiations to reduce trade barriers is economic nonsense, in spite of its political appeal and past effectiveness. Additionally, certain sectors of importance to developing countries and low-cost producers in developed countries, such as agriculture and textiles, have been excluded from the trade-liberalising process. Yet developing countries now account for the bulk of membership of the World Trade Organization (WTO).

The WTO is the body that administers the agreements on trade between nations that forms the basis of the multilateral trading system. It was established in 1995, and replaced the secretariat to the General Agreement on Tariffs and Trade (GATT) established after World War II. The WTO system provides a framework of *internationally agreed* principles and rules. Member countries adhere to these principles and rules because they deem them to be in their long term interests. In that sense, the WTO system is a voluntary club. If countries lose confidence in those principles and rules, which are administered by the WTO's own membership through its ministerial conference and a number of councils and committees, their adherence to them will weaken over time. The whole system will then

deteriorate. This happened in the 1970s and 1980s under the GATT system.

The breakdown of the GATT system then was largely due to the major developed countries exploiting 'exceptions' to the rules to treat agriculture and textiles as special cases, placing them outside the trade-liberalising process. The Uruguay Round negotiations of 1986–94 were a major step forward in correcting that situation. But time and patience ran out before trade barriers for agricultural products could be reduced as for industrial products. Following half a century of neglect, the WTO system can only fall into disrepute with the bulk of its membership unless agriculture and textiles are fully integrated into the multilateral trade-liberalising process. Developing countries, as well as smaller developed states, will gradually cease to adhere to the spirit and letter of international trade rules.

The mixed messages conveyed by mercantilist, discriminatory and protectionist ideas have led to confusion and muddled thinking about the framework of principles, rules and procedures — the 'rules of the road' — governing the conduct of trade policy. Without coherent principles and a set of conforming rules to guide 'due process', the way forward in liberalising international trade will be tortuous. The inconsistencies, loopholes and flawed rules plus mercantilist thinking are, like termites in the basement, gnawing away at the foundations of the WTO system. Unless fixed, at best we could witness the slow demise of the WTO system. At worst would be the disintegration of the system into a chaotic plethora of discriminatory trade arrangements, bilateral and regional, with trade conflicts breaking out all over — the very thing the multilateral trading system was formed to prevent. In such a world, the transaction costs of conducting trade would rise, the growth of world trade would slow and the world economy would be less competitive, vibrant and innovative as a

result. Further, if the past is any guide, it would not take long for trade conflicts to politicise into something much worse.

To prevent all this, the WTO system should be aimed solely at achieving and maintaining open, multilateral and non-discriminatory trade where goods and services from any part of the world can be freely exchanged. It should be based on free-trade principles, private enterprise and open competition. Any departures from this course should not be allowed without prior open and independent economy-wide analysis of the benefits and costs of government intervention in the market process.

Getting to that point is difficult, but possible. The key element is to build on the WTO's Trade Policy Review Mechanism (TPRM) introduced during the Uruguay Round, and make two changes to it. These two changes to the TPRM are a natural progression towards better public policy. The first is to include economy-wide analysis of the costs and benefits of the trade policy measures of the country under review. The second is to change the review process along the lines outlined in this study. The main element of this process is an open, independent and transparent analysis, repeated systematically on a regular basis in each of the capitals of members countries. Economy-wide analysis *combined* with due process changes the *politics of protection*. It makes sense — it is basic good governance — and it has been shown to work in securing trade liberalisation in other countries.

One drawback with independent economy-wide analysis in an open transparent process is the time it takes to work. It takes time both to educate the public and policymakers on the benefits of trade liberalisation, and to form coalitions for reform from among those bearing the burden of protection. These coalitions are needed to lobby for change.

Meanwhile, there are nine useful steps that can be advanced, consistent with the above, that will enhance the prospects of a successful outcome of the Doha Round negotiations. First is to convince the public that the WTO system is in trouble, threatening the health of economies worldwide. Without progress on agriculture and the other repair work outlined in this study, there will simply not be enough benefits for the members of a voluntary club to willingly continue to adhere to the rules.

Second, agricultural market access must be the priority for reform. Eight reasons why greater market access should be a higher priority than either export subsidies or domestic support are identified in the final chapter. These reasons are all grounded in economic theory and make political sense as well.

Third, an international study of structural adjustment as a consequence of trade liberalisation is required. Although farmers fear adjustment, evidence from limited reforms in agriculture shows adjustment costs are over-exaggerated and industry efficiency rises as a result of liberalisation.

Fourth, the spirit of the second part of the United States' original proposal in the Doha Round negotiations on agriculture should be acted on. The proposal, loosely paraphrased, was for countries to nominate the date by which they were prepared to eliminate all trade-distorting policies in agriculture. This will make it apparent who the 'slowest ships in the convoy' are. There may be enough wanting to go to free trade that could do so now on a multilateral most-favoured nation basis. And the forward-looking goal by which progress could be monitored would be clearer. The current method of measuring progress by where we have come from may make for great headlines, but it has given little real progress in agriculture.

The fifth short-term imperative is to demonstrate that preferential access to markets is not helping developing countries. Rather, in many cases it is harming their interests. Preferential access also sets up a perverse incentive: countries argue *against* global liberalisation to preserve their preferences in the false belief they provide net benefits to their country.

The sixth step requires economics to be put into anti-dumping assessments of injury by including an appraisal of the benefits accruing to consumers through 'dumping'. Current 'injury tests' do not adhere to world best practice in public governance as there is no balanced assessment of the costs and benefits of dumping. Anti-dumping duties are basically protectionism.

The seventh step is to focus on the rules of the world trading system first rather than any shortcomings in the organisation administering the rules, the WTO. There are shortcomings in the WTO, but having the best people in the world with as many resources as required will come to nought if they are administering rules that are wrong or flawed. Indeed, there is a danger that attention is deflected away from the needed reforms if the focus is on the organisation rather than the institutional rules.

The final two steps are needed to implement the previous seven. An expert group is required to think through these issues and develop a 'game plan' for action. Besides the issues above, the other problems identified in this study governing dispute settlement, safeguards, free trade agreements, the use of reciprocity and 'concessions' to secure liberalisation and the potential for 'new areas' to make matters worse, all need to be worked through. In the past, such expert groups have helped to restore the world trading system. The problem is that too few previous recommendations have been acted on. There has not been enough ownership of the recommendations. So the final step is to

build ownership of the findings of the expert group and create a groundswell of support for change. The best way to do this is through a series of informal meetings of key ministers, officials and trade experts. Again, there is a successful precedent here — the series of meetings that led to the launch of the Uruguay Round negotiations.

While the nine steps above will progress trade liberalisation in a reasonable timeframe, ultimately the two overriding mistakes in the WTO system's failure to liberalise trade are, like other areas of bad economic policy, first to ignore the secondary or economy-wide effects of trade policy, and second to ignore 'due process'. Only when the economy-wide effects of trade policy are systematically and routinely reviewed through open, transparent and independent processes will free trade be secured. Such a process does two things. It changes the mindset of policymakers and the public, and it identifies the stakeholders bearing the burden of protection. As these stakeholders become aware of who they are and what they are losing, incentives arise to form coalitions and tip the political balance in favour of reform *within the country*. The process has been shown to work in the few countries that have tried it. Clear thinking changes the politics of liberalisation and it will put the WTO system onto a more secure and durable foundation. Trade liberalisation is the likely result. On World Bank figures, some 320 million people will be lifted out of poverty and world output will expand by US\$2.8 trillion — not a bad payoff from a bit of institutional repair.

1 INTRODUCTION

Clearly, something is wrong with the international trading system. Failure of the ministerial trade meetings in Seattle in 1999 and Cancun in 2003 shows there is no consensus in liberalising world trade. Indeed, some believe that without the tragic events of September 11, 2001, there would be no Doha round of trade talks launched at all.²

What is going on here? The World Bank has shown that a successful round of trade liberalisation would lift 320 million out of poverty and lift world income by US\$2.8 trillion by 2015, of which US\$1.5 trillion would accrue to developing countries.³ A similar picture emerges from analysis by the IMF.⁴ Yet, somehow, members of the World Trade Organization (WTO) have shown themselves incapable of making the decision to remove barriers and distortions to world trade.

No single one-line sentence can describe this problem, nor is there a simple 'silver bullet' answer. Some say the problem is the refusal to budge on agricultural protection in rich countries. Others point to the capture of the WTO by the thousands of non-government organisations (NGOs),

² Razeen, S. 2003, 'Wither the WTO? A progress report on the Doha Round', CATO, *Trade Policy Analysis*, no. 23, p. 15.

³ World Bank 2002, *Global Economic Prospects and the Developing Countries*, Washington DC, p. 176.

⁴ International Monetary Fund 2003, *World Economic Outlook: Trade and Finance*, Washington DC, p. 85.

turning it into a United Nations style development agency.⁵ Yet others point to a lack of political will to deal with protectionist pressures. Some place the blame on the bad deal developing countries got from the Uruguay Round. The lack of leadership by the United States and the European Union, and their insufficient preparatory work before the meetings are often cited as prime causes of the failure of the talks in Seattle and Cancun. Actually, in different ways all of these issues are part of the problem. But they are all interconnected.

The problem of the lack of trade liberalisation is complex and multifaceted. But most of the problems behind the failure to liberalise trade can be traced to flaws in the institutional arrangements of the WTO system. Some of the rules and agreements are internally inconsistent. Some of the negotiating positions advanced by major players on different issues are incongruous with each other. Some rules are economically wrong and other exceptions are either so riddled with loopholes or so ill-defined that anything goes. On top of that, the negotiating game using reciprocal trade concessions to reduce trade barriers is logically flawed on economic grounds. Negotiating 'concessions' sends the wrong message to the voting public about the benefits of trade. No wonder there is confusion and muddled thinking by trade ministers, trade officials and the public.

Flawed logic, exceptions and loopholes that have become the norm, plus inconsistent rules and wrong laws, are all eroding the consensus for a commitment to a stable, open, multilateral world trading system. Like termites in the basement, these deficiencies are slowly, almost unseen, eroding the foundations of the WTO's institutional arrangements. These problems need fixing in their own

⁵ Razeen 2003, p. 15.

right, but will also garner support for freeing up trade in critical areas such as agriculture. A weak outcome for agriculture in the current Doha round will add to the erosion of the WTO's institutional arrangements. Together with the other problems gnawing away at the foundations of the WTO system, not dealing effectively with agriculture will jeopardise the future workability of the entire structure. This will not happen in one hit, but over time. The danger is that the WTO system will be weakened gradually to the point where it is unworkable. Perhaps this point has already been reached.

Basis of the GATT/WTO system

The next chapter handles just what the multilateral system of international trade rules administered by the WTO stands for. Understanding this framework and some of the history of the GATT and the WTO is necessary to appreciate the nature of the termites that are eroding the foundations of the WTO system.

Importance of agriculture

The importance of agriculture to many developing countries (as well as members of the Cairns Group) means a weak outcome on this issue will only lead to cynicism and a lack of confidence that the WTO system can meet their interests. International trade law relies on the consent and commitment of countries to 'play by the rules', and the WTO has no police force or army to 'prosecute' violators of the rules. Even the notion of sanctions by aggrieved parties of the WTO club is flawed — this is dealt with later. Rather, enforcement comes from all members of the WTO club realising that it is in their own interests to have a set of international rules governing liberal trade and to comply with them. If the largest members of the WTO openly

flaunt, in spirit if not in narrow legal terms, the WTO's underlying principles of trade liberalisation in a major area like agriculture, the system can potentially collapse.

The problem of agriculture is partly a result of the other deficiencies in the WTO system, but agriculture's special treatment means it has become a major termite in its own right. Without securing agreement on agriculture, commitment to the WTO system of rules will be less forthcoming by a large number of countries — especially developing countries. Liberalising agricultural trade is a key ingredient to reinvigorating an open international trading system that leads to growth and prosperity. With agriculture of central importance to the success of the Doha round of trade talks, and hence of the WTO system itself, chapter 3 gives a synopsis of the agricultural trade problem and what may be done about it.

Reciprocity

Another termite eroding the foundations of the WTO is the multilateral trade negotiations (MTN) mechanism for securing reductions in protection. Central to MTN talks is the notion of reciprocity, where both sides walk away from the negotiations with 'something of comparable value'. But this leads to a negotiating game between countries where securing more access for exports is treated as a gain, and giving concessions to extra imports is seen as a loss. In the past, this mercantilist approach of 'exports good, imports bad' has changed the political dynamic of protection and actually helped secure trade liberalisation. But it is a dangerous game and it has now backfired. The reason? The 'exports good, imports bad' message is dead wrong. Generations have been miseducated on the real value of free trade, making the going that much tougher. Just why a principle based on lousy economics is a cornerstone of

trade negotiations is considered in chapter 4, which necessarily touches on the logic as well as the political economy behind multilateralism and the international trading system.

Dispute settlement and enforcement

Every club has rules governing the behaviour of its members. There must also be mechanisms to decide when the rules have been broken and how to enforce them. Otherwise, there is no incentive to abide by them. The dispute settlement mechanism and enforcement arrangements introduced with the WTO as part of the Uruguay Round agreement is often hailed as a success. In many respects, it is a major advance on previous dispute settlement procedures. But it has two of its own inherent termites, which undermine the basis of international agreements at the heart of the WTO system.

The first problem deals with deciding when the rules have been broken. The origin of this problem is the need for consensus in setting international rules and the difficulty and time required to get consensus from 148 member states. Consensus requires diplomacy and language that is sometimes ambiguous so all parties can agree to it. But dispute settlement requires these ambiguities be clarified. In doing so, the dispute settlement mechanism has become a lawmaker rather than an interpreter of law. The inherent problem is that the dispute settlement mechanism is quite quick, but lawmaking through diplomacy and consensus of the members is slow. Why this matters and what might be done about it is dealt with in chapter 5.

The second problem concerns enforcement of the WTO's rules. Enforcement mechanisms are sanctions and retaliation procedures permitted under the WTO's institutional arrangements against members that break the rules. But

these mechanisms are based on faulty economics, just like the notion of reciprocity. A country imposing sanctions on another hurts itself. Small countries cannot afford to retaliate when disputes are ruled in their favour. Yet one of the pillars of the multilateral rules-based trading system is that it should protect the small and weak against the strong. Just why there is no effective discipline to aid small players and what might be done about it is also addressed in chapter 5.

Preferences and developing countries

One of the major changes in the GATT/WTO system has been the growth in members, from 23 at the original signing of the GATT in 1947 to 148 today. Two challenges are presented by this growth in numbers. The first is the difficulty of achieving consensus among so many disparate members. The second is that over 100 of the members are developing countries. Their interests loom large in the Doha round of talks, officially labelled the Doha Development Agenda.

There are many aspects to developing countries in the WTO system. One, for example, is their lack of resources and expertise necessary to come to grips with a complex and sometimes contradictory body of international law. But to place the WTO's foundations on a better footing, two issues require important repair work. The first relates to the special and differential treatment given to developing countries in the WTO institutional arrangements. These special provisions cover both special and differential treatment — in effect, leniency for developing countries for commitments and implementation — and preferential access to rich countries' markets. Special and differential treatment can make sense since developing countries sometimes do not have the capacity to fully or quickly

implement agreements. By contrast, preferential access for developing countries does not make sense. Preferential access to the markets of rich countries looks, on the face of it, like a worthwhile initiative. After all, developing countries have a high incidence of poverty and a great need for development. But preferential access is not in the interests of an open world trading system: it erodes one of the most basic pillars of the GATT/WTO system — the most-favoured nation (MFN) principle. This termite is serious. Left unattended it will continue to erode one of the pillars of the international trading system, ultimately weakening it.

Nor does preferential access work in the interests of developing countries. It creates the perverse incentive whereby developing countries oppose liberalisation for fear of losing their preferential access to rich markets. And it creates a victim mentality that leads them to demand access from others while giving nothing in return. Yet it is their own barriers to trade that hurt developing countries the most. An explanation of this counter-intuitive result is in chapter 6.

Also discussed in chapter 6 is the second issue regarding developing countries, namely the relative importance of agriculture in their economies due to their stage of development. Failure to deliver a strong outcome on agriculture, as noted earlier, is a contentious issue with many developing countries.

Bilateral free (preferential) trade agreements

Special and differential treatment for developing countries is not the only termite gnawing away at the MFN principle that is so fundamental to the WTO system. Another is the exemption under GATT Article XXIV allowing countries

to pursue bilateral free trade agreements (FTAs). The problem is these FTAs are preferential and consequently fly-in-the-face of the MFN clause. This bilateralism is now rampant, even though it is not the preferred path to free trade and can weaken the multilateral trading system. Just how this happens and what to do about it is covered in chapter 7.

Safeguards and anti-dumping

Agreeing to rules on international trade constrains the ability of governments to intervene in trade. Some of this is useful to governments because it allows them to resist domestic protectionist pressure. But flexibility to act in the face of some circumstances is also valuable, so governments are not willing to enter into binding agreements without some 'escape clauses'. These escape clauses — better known as safeguards — are just more exceptions to the rules, to be applied in special circumstances. When they become applied liberally, it is obvious the rules have lost their value. And one safeguard — that dealing with anti-dumping — is simply a bad bit of law as it offers protection through the 'back door'. Clearly, a bad bit of law running counter to the principles of the WTO system will, over time, weaken that system. Escape clauses to the GATT are dealt with in chapter 8.

New issues

As global integration deepens, the WTO system has turned its attention to a host of 'new area' issues. During the Uruguay Round new areas were services, sanitary and industrial standards, and intellectual property (resulting in the Trade-Related Intellectual Property Rights (TRIPs) agreement). Since then, there have been attempts to include labour and environmental standards in trade policy as well

as the four ‘Singapore’ issues of investment, competition policy, transparency in government procurement and trade facilitation.

But some of these latest issues reflect and extend muddled thinking over the purpose and role of the WTO system. They could exacerbate the erosion of the WTO’s foundations and, if left unattended, weaken the system further. As some aspects could end up being blatant protectionist measures, it is important to explain the objectionable aspects of these new areas. That is done in chapter 9.

What to do

Fundamentally, the WTO system does not incorporate or encourage world’s best practice principles of good public governance, such as openness, transparency and accountability. The WTO will have to embody these sound principles if it is to be successful. Otherwise, the organisation will be captured by a myriad of interest groups and the system will become unworkable. The WTO system must be based on a coherent set of consistent principles so trade policies can be evaluated against these principles, allowing good policy to evolve. There are two aspects: sorting out what to do, and how to do it. The GATT/WTO’s handling of crises in the past provides some valuable precedents here.

Although not recognised widely in the media at the time, the system was nearing collapse in the early 1980s — not long after the Tokyo Round Agreements were signed in 1979. Two things stand out in the resolution of this crisis. The first was a series of informal roundtable meetings convened by the (then) London based Trade Policy Research Centre. These meetings contributed to consensus building at inter-governmental level, helping to restore the GATT system and to initiate the launch of the Uruguay

Round. The second key event was the establishment of the Leutwiler expert group by Arthur Dunkel, then Director-General of the GATT Secretariat. This group, made up of seven experts, produced the Leutwiler Report.⁶ Many of the ideas in that report were adopted, the Uruguay Round was launched in 1986 and some badly needed repair work was undertaken. This example is important for it sets a model by which the contemporary repair work could be identified and undertaken.

However, some of the earlier repair work, such as the introduction of the transparency principles of the Trade Policy Review Mechanism (TPRM) as part of the Uruguay Round, was only partially successful. The TPRM was one of the repair innovations that potentially could have exterminated some of the termites, but it has failed to do so because of major deficiencies in good public governance. How to fix both these deficiencies and some of the other repairs identified in this study is clear, at least conceptually. Other solutions, however, need to be thought through and developed further. These ideas are brought together and summarised in chapter 10. It is suggested that another expert group, similar to the Leutwiler Group, be established to further refine these solutions. This group would build on this and many other previous studies to identify and recommend today's necessary repair work. This work would be implanted into the process through a series of informal meetings involving key trade ministers, officials, business leaders and independent experts. Such a process worked in the past to secure a consensus to build a commitment to a well-working WTO system. The prize is more open and expanded trade, and higher growth and prosperity to the benefit of all countries.

⁶ Leutwiler, F. 1987, *Trade Policies for a Better Future: The 'Leutwiler Report', the GATT and the Uruguay Round*, Martinus Nijhoff Publishers, Dordrecht, The Netherlands.

2 HISTORY AND BASIS OF THE GATT/WTO SYSTEM

Understanding some of the termites weakening the foundations of the multilateral trading system requires an understanding of the history of the GATT and, later, the WTO, and the political economy forces that led to their establishment. Some of the current weaknesses in the system have been apparent from the start. Others arose as exceptions became the norm. Yet other weaknesses evolved from previous half-hearted attempts to repair the system.

Many books on trade policy, the GATT and the WTO deal with the history of the General Agreement, along with the GATT Secretariat that administered the General Agreement, which later, in 1995, became the WTO.⁷ The GATT was negotiated in 1946-47 by the United States and Britain, and was later joined by others -- the final agreement had 23 signatories. The inter-governmental agreement entered into force in 1948.

⁷ For a history of the intellectual case for free trade see Irwin, D.A. 1998, *Against the Tide*, Princeton University Press, New Jersey, while Dam, K.W. 1977, *The GATT: Law and the International Economic Organization*, University of Chicago Press, gives a good description of the General Agreement and Hoekman B.M. and Kostecki, M.M. 1995, *The Political Economy of The World Trading System: From GATT to WTO*, Oxford University Press, give a history of the GATT/WTO. Only the salient points relevant to the argument are given here in this potted history.

The original intention was to create an International Trade Organisation (ITO) as part of the international economic order conceived at the Bretton Woods conference in 1944. The other institution conceived then was the International Monetary Fund (IMF). A third institution, the World Bank, (not strictly a part of the international economic order), was also formed at that time. But after World War II, the ITO Charter was stillborn. It was heavily criticised in the United States for a variety of reasons, primarily for going too far.

The motivations for a multilateral framework of principles and rules were virulent economic nationalism in Europe following World War I and the beggar-thy-neighbour policies of the 1920s and 1930s that culminated in the Great Depression. Disastrous errors in the conduct of economic relations during the inter-war period were made. The period was judged a 'colossal failure'.⁸ A multilateral system of internationally agreed rules was seen as a necessary discipline on governments to help them resist the protectionist pressures of sectional interests in their domestic constituencies.

The motivation for establishing the GATT was to promote liberal trade and economic growth, to build co-operation among countries and to foster peace. Cordell Hull, Secretary of State in the United States, inspired planning for the international economic order established after World War II. He believed that peace was 'indissolubly connected with friendliness, fairness, equality and the maximum practicable degree of freedom in international trade'.⁹ The

⁸ Hudec, R.E. 1975, *The GATT Legal System and World Trading Diplomacy*, cited in Viravan A. and others 1987, *Trade Routes to Sustained Economic Growth*, Report for the United Nations by a Study Group of the Trade Policy Research Centre, St Martin's Press, New York, p. 1.

⁹ Dam, K.W. 1970, *The GATT: Law and the International Economic Organization*, University of Chicago Press, Chicago and London, p. 12, footnote 5.

GATT therefore had strong undercurrents of both economics and politics.

In the effort to establish the ITO, the United States took a strong position, arguing that tariffs should be the only permitted instrument of protection, flatly prohibiting non-tariff barriers. Further, all tariffs should be reduced through international negotiations. The right of governments to interfere with private trade should also be severely limited. And the ITO should have the power to enforce the codes of conduct akin to that of a court.¹⁰ But other countries were opposed to these aims for various reasons.

Since international law can only work with countries' voluntary consent to the rules, it was necessary to seek consensus among member countries on the aims of the ITO. The resulting code proposed by the United States was consequentially 'shot full of holes'.¹¹ First, the United States Department of Agriculture insisted on exempting agriculture from the rule against quantitative restrictions. The British then insisted on maintaining imperial preference arrangements, expecting they would be eroded as tariffs were reduced. Other countries sought exceptions to other rules. Kenneth Dam quotes an editorial in *Fortune* magazine describing how the 'greater part of the charter consists in exception, enumerating all the ways in which governments so inclined can flout the objectives and control their own trade'.¹²

In the end, President Truman decided not to seek Congressional approval for the ITO Charter and so it died. In the meantime, the GATT, incorporating the ITO's trade policy provisions, was signed to underpin the first round of tariff cuts agreed in October 1947. The GATT was to be an

¹⁰ Dam 1970, pp. 12–13.

¹¹ Dam 1970, p. 14.

¹² Dam 1970, p. 14, footnote 10.

interim device until the ITO Charter could be approved at the Havana conference in March 1948, ratified and brought into being.

But when the ITO Charter came to grief, the GATT, with a temporary secretariat in Geneva, became the *de facto* world trade organisation.¹³ In 1995 the World Trade Organization was formally established as one of the outcomes of the Uruguay Round negotiations. The WTO administers the GATT, as substantially amended, the General Agreement on Trade in Services (GATS) and the Agreement on TRIPS. It also administers a number of lesser agreements, including the Agreement on Agriculture, as well as the TPRM and a body of dispute-settlement procedures. Additionally, the WTO provides the framework for conducting successive rounds of multilateral trade negotiations aimed at reducing barriers to trade, tackling other trade-distorting measures and ensuring non-discriminatory market access.

This potted history highlights the fact that many of the WTO's problems have been with the multilateral trading system from its conception. This is particularly so because international law requires consensus. Without an international police force, although international 'pressure' can be brought to bear, in the end compliance with WTO rules must be voluntary. So members of the 'club' need to determine a set of rules that are in all their interests.

But there are different views among countries about the extent of regulation and government involvement in the economic system. Members of the WTO now range from a few command economies to a large number of representative democracies. Consensus therefore depends on two practicalities: first, sometimes ambiguous language has to be used, allowing members to seek solace in their particular

¹³Hoekman, B.M. and Kostecki, M.M. 1995, *The Political Economy of the World Trading System: from GATT to WTO*, Oxford University Press, p. 13.

interpretation of words; second, exceptions or ‘escape clauses’ have to be permitted for governments not to be totally bound by the agreed-upon rules. While a set of international trade rules without exceptions would be nice (let alone fair), the reality is that countries will not sign a binding international trade agreement without escape clauses for ‘exceptional circumstances’.

These ambiguities and exceptions create some of the problems today. It is an interesting political economy question why many of the ‘termites’ eroding the foundations of the WTO system from the start have not been repaired before. Why is it that subsequent efforts to repair the foundations have only had mixed success? But before these questions can be considered, an examination of why we have the WTO system at all is necessary.

Why have a WTO?

The bitter experiences of the collapse of world trade in the 1930s made a major impact on the farmers of the multilateral trading system. The *raison d’être* of the system was to prevent future trade wars and to foster peace.

The beggar-thy-neighbour policies and competitive devaluations of the 1930s were partly a result of the mistaken belief in mercantilism at a political level. That belief was that exports were good, but imports were to be minimised in order to accumulate as much foreign reserves — mainly gold and silver — as possible. The more foreign reserves a country accumulated, the wealthier and more powerful they were. Although great economists such as Adam Smith and David Ricardo had shown mercantilism to be economically wrong, mercantilist thinking managed to creep into the framework for conducting multilateral trade negotiations under the GATT. Mercantilist thinking prevails in nearly all ministries of trade around the world today. These depart-

ments promote exports, but never promote imports; in fact, most work to prevent imports if they can. This undercurrent of mercantilist thinking has now become a major obstacle to liberalising trade, and is followed up in chapter 4 under reciprocity.

To ask ‘why have a WTO?’ may raise eyebrows, as most economic commentators believe that establishing the WTO system has been a great achievement. Indeed, Martin Wolf argues that the WTO is an effective system of international economic law and ‘is the greatest achievement in institutionalised global cooperation, *tout court*’.¹⁴

The purpose of the WTO system is to foster liberal and non-discriminatory trade. But the case for free trade, as has been made countless times, is essentially unilateral. The familiar analogy used by Paul Krugman¹⁵ and Jagdish Bhagwati,¹⁶ among others, is that just because someone throws rocks in their harbours does not mean you throw rocks in your own. Unilateralism implies that, on economic grounds, there is no need for a WTO system. Every country, acting out of self-interest, will open their borders to imports and have an incentive to keep it that way. Neither the framework for negotiating progressive reductions in trade barriers nor the rules stopping government intervention in trade would be necessary. Commercial firms and individuals would freely exchange goods and services. All that would be required is enforcement of property rights and contracts by each government — a necessary condition for a market economy in each country in the first place.

¹⁴ Wolf, M. 2001, ‘What the world needs from the multilateral trading system’, in Sampson, G.P. (ed), *The Role of the World Trade Organization in Global Governance*, United Nations University Press, Hong Kong, p. 186.

¹⁵ Krugman, P. 1997, ‘What Should Trade Negotiators Negotiate About?’, *Journal of Economic Literature*, vol. XXXV, pp. 113–20, March.

¹⁶ Bhagwati, J. 2002, *Free Trade Today*, Princeton University Press, New Jersey.

Indeed, many countries have successfully liberalised trade unilaterally. Bhagwati notes the 'empirical reality shows extensive resort to unilateral trade liberalization in the last two decades in Eastern Europe, in Latin America (especially Chile), in Asia (especially in Australia, New Zealand, and Indonesia, and since 1991 in India as well), and yet earlier in Singapore and Hong Kong'.¹⁷

Another interesting piece of research shows there is no compelling empirical evidence showing that the GATT/WTO has actually encouraged trade.¹⁸ The vast majority of economic commentators would reject that notion, but the point remains: to justify having a WTO, it must enhance one or both of its major functions — the liberalisation of trade and the application of law. This latter function implies transparency, stability and predictability in the conduct of international trade and trade-related investment.

The logical case for a multilateral organisation to administer a framework of rules to liberalise trade is twofold. First, with all countries acting together to liberalise trade, the gains are much greater while the adjustment costs are much smaller. Although, the case for free trade is unilateral — as Bhagwati notes, 'if others do liberalize in return for one's trade liberalization, then we gain twice over'.¹⁹ Twice over here does not mean twice the dollar benefit of liberalisation — it simply means there is an additional gain. Liberalisation studies using economy-wide models show that in a multilateral round of tariff cuts, typically 80 or even 90 per cent of the gains accrue to a country's own actions and not

¹⁷ Bhagwati 2002, p. 105.

¹⁸ Rose, A. K. 2002, 'Do we really know that the WTO increases trade?' Centre for Economic Policy Research, *Discussion Paper Series No. 3538*, London, pp. 1–8.

¹⁹ Bhagwati 2002, p. 102.

the actions of others.²⁰ Nevertheless, the greater gains and lower adjustment costs from multilateral reductions can be important, especially if the society has a conservative social welfare function weighting losses more heavily than corresponding gains.

The second advantage of the multilateral approach is that, through the reciprocal exchange of requests, the political dynamic of protection is changed. Reciprocity in trade negotiations is a subject in itself, since it contains its own subliminal termite, and is dealt with in chapter 4. But the advantage is that reciprocity pits the exporters within a country who stand to gain from the removal of barriers to their sales to foreign countries, against those groups wanting protection from imports. Why this is important stems from the failure of governments, democratic or otherwise, to not always make the best decisions. Governments can become captured by narrow vested interest groups who effectively lobby for benefits for themselves against the common good. The burden of this protection is spread thinly over society, so it does not pay any one person to become informed on the merits of protection, or even if they are, to do anything about it. But reciprocity identifies the exporters, enabling them to form coalitions in favour of free trade counter to the protectionist groups.

Under the multilateral removal of trade barriers there is also the notion of 'fairness' — that everyone is seen to be acting together has its own political appeal.

The case for multilateral rules governing international trade stems from the argument that a working system of international law constrains the behaviour of the most powerful states and 'protects the world economy from arbitrary

²⁰ Stoeckel, A. 1999, 'Removing the hidden taxes on exports', in Stoeckel, A. and Corbet, H. (eds), *Reason versus Emotion: Requirements for a Successful WTO Round, Seattle 1999*, RIRDC Publication No. 99/167, Canberra, chart 1, p. 82.

political interference and government from narrow sectional interests'.²¹ As expressed by Stoeckel and Corbet, 'the purpose of the multilateral trading system is to provide a stable institutional environment in which private enterprises know where they stand *vis-à-vis* their governments, and the governments of other countries, so that they can make decisions of long term significance, so that they can plan for expansion or if need be for adjustment. It is thus that the GATT, and now the WTO, facilitates economic growth and development. Economic growth, after all, is a continuous process of adjustment to change — to changes in patterns of demand, to advances in technology, to shifts in comparative advantage and so on'.²²

In other words, as Tumlrir notes, international trade rules exist to protect the world market against governments.²³ But the rules governing international trade are not always consistent. There is a rule that says, in effect, 'dumping (including of agricultural products) is wrong', but another agreement says, in effect, 'dumping is all right for agriculture'. One rule says 'quotas are illegal', but the effect of another is that 'quotas for agriculture are all right'. There are definitional problems related to this: at what stage does an agricultural product become a manufactured good? Sugar and cocoa are agricultural, but what about chocolate?

Yet another rule prohibits discrimination between goods from alternative supplying countries. However, another rule allows exceptions from this rule for the formation of free

²¹ Wolf 2001, p. 185.

²² Stoeckel, A. and Corbet, H. 2002, *Opportunity of a Century to Liberalise Farm Trade: Rapporteurs' Report with a Chairman Statement by Clayton Yeutter, Cordell Hull Institute's Meeting at Airlie House, Virginia*, RIRDC Publication No. 02/126, Canberra.

²³ Tumlrir, J. 1987, 'International trade regimes and private property rights', *Contemporary Policy Issues*, Los Angeles.

trade areas. No surprise this is where the growth area is today.

Clearly, the rules do not always work and certainly they are not applied consistently. These inconsistencies, exceptions and loopholes are weakening global compliance and acceptability of the WTO system. No wonder governments around the world are muddled in their thinking on trade. This muddled thinking spills over into public debate, further eroding the public's understanding of the gains from liberalising trade. Nowhere is that lack of public understanding more apparent than in agriculture, and that issue is taken up next. But the point for now is the WTO system is not delivering on its two key mandates — trade liberalisation, in the case of agriculture, and the application of consistent international trade rules, which must be of value to its members to ensure compliance. Unless these are fixed now, the WTO system will, at some point, become irreparably damaged.

3 AGRICULTURE

Mankind, it seems, has a sweet tooth. Sugar, among other sweeteners, is an important commodity produced by the world's farmers. Brazil has vast tracts of tropical land, water and sunshine suitable for sugarcane. It is the world's lowest cost sugar producer and has both absolute and comparative advantages in sugar production. Brazil is so efficient at producing sugar that it can do so for one-fifth of the cost that it takes to produce sugar in the European Community. Land is scarce there, sunshine less plentiful, and sugar is extracted from a less productive, temperate plant — sugarbeet. Astonishingly, Brazil does not export sugar to the European Union, but competes with the European Union as an exporter.

This perverse situation comes about through protection against imports and the use of domestic and export subsidies for the European Union's sugar farmers. Without these government policies, the European Union would be the world's largest importer of sugar.²⁴ Instead, it is one of the world's largest exporters.

This illustration shows how massive the distortions in world agriculture can be. Agricultural distortions are now so immense that fixing them is no longer just a matter of helping some sugar (or other farmers) around the world. The scale of abuse of this sector and the inability of the

²⁴Borrell, B. and Hubbard, L. 2000. 'Global economic effects of the EU Common Agricultural Policy', *IEA Economic Affairs*, Institute of Economic Affairs, Oxford, pp. 18–26.

WTO system to deal with it is threatening the whole multilateral trade system.

As previously highlighted, membership of the WTO system is voluntary, so continual commitment to the system depends on it delivering benefits to members. Clearly, the lack of free agricultural trade could initiate member disillusionment. Other problem areas where the WTO system is not delivering then interact with the agriculture trade problem to make it worse. Combined, these problems may prove fatal.

The agricultural trade impasse

World trade talks aimed at liberalising trade have again reached an impasse on the issue of agriculture, as they did in the Uruguay Round. The Uruguay Round concluded in 1996, after much time and acrimony, with only a weak outcome for agriculture. In fact, since then assistance for some major rural industries has even *risen*.²⁵ With sustained reductions in protection for manufactured products, agriculture remains one of the most highly protected sectors around the world today. Tariff equivalents of 200 or 300 per cent are not uncommon for some commodities.

Agriculture was exempt from the GATT's disciplines right from the outset, continuing through to and including the Tokyo Round of trade negotiations. In the late 1970s, the United States and the European community decided to take agriculture off the Tokyo Round negotiating table rather than jeopardise an agreement on industrial products.

²⁵ For example, OECD figures show the producer support estimate for beef farmers has risen from 61 per cent in 1996 to 79 per cent in 2001 — a time when support should have been falling. See OECD 2003, *Agricultural Policies in OECD Countries: Monitoring and Evaluation 2003*, Paris.

Exempting agriculture from GATT rules meant there was no discipline in the use of subsidies or border protection. Consequently, protection for agriculture rose strongly in the lead-up to the Uruguay Round negotiations that commenced in 1986.

The Uruguay Round Agreement on Agriculture had mixed success. It was certainly a success that agriculture was brought into the formal framework of the GATT/WTO system for the first time. The agreement also established a framework by which negotiations to liberalise world agricultural trade could continue. However, to conclude the Uruguay Round, a compromise deal was also negotiated between the United States and the European Community — the so-called ‘Blair House Accord’. Elements of that compromise have potentially made matters worse, particularly institutionalising quotas in the agricultural agreement.

The Accord introduced a system of tariff rate quotas for many commodities around the world. Many of the over-quota tariffs are effectively prohibitive. But quotas are particularly bad instruments of protection. They shield the domestic industry from any market forces and so prevent any adjustment to changing international supply and demand conditions, however caused. As Tumlrir notes, ‘quantitative restrictions by contrast [with tariffs] are a much more damaging protective device because they paralyse the price system in the area of application’.²⁶ For this reason, quotas have long been banned from other manufactured goods under GATT Article XI.

A good example of the power of shifting protection from a quota to a tariff is in the beef market in Korea. As part of the Uruguay Round, the Korean government shifted to a tariffs-only policy to protecting its local beef industry.

²⁶ Tumlrir 1987.

Although the tariff protection of 40.5 per cent for imports of beef into Korea provides a degree of 'comfort' for the local industry, the tariff does not interfere with the functioning of the price system. The result has been a shift to market-oriented principles in the Korean beef industry. Much structural adjustment occurred as the industry moved to a more commercial footing. This has made future liberalisations for beef by the Korean Government easier.²⁷

Another problem with quotas is that they become valuable in the hands of their owners. Because trade liberalisation could erode this value, there is an inbuilt incentive for some countries to argue for continuing existing arrangements to protect their quota values. This clearly works against liberalisation of agricultural trade.

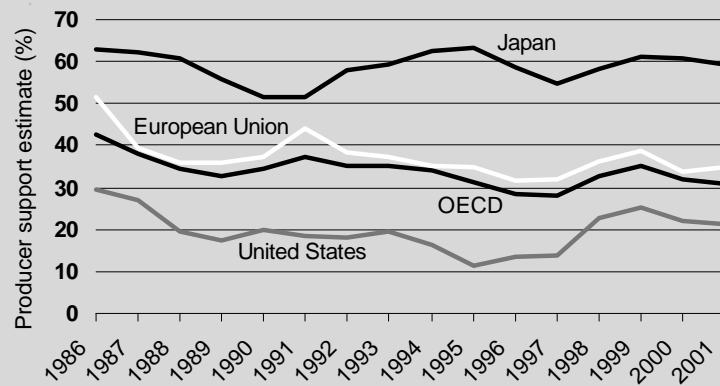
A weak aspect of the Uruguay Round Agreement from the Blair House Accord was that little actual liberalisation of agriculture was secured. As measured by the Organisation for Economic Co-operation and Development (OECD), the average producer support estimate (PSE) for agriculture amongst OECD countries has barely changed since the heydays of assistance offered at the start of the Uruguay Round (chart 1).

Economic costs of support

The OECD average figures conceal much and convey nothing about the true economic cost of the assistance. Protecting agricultural industries has an economic cost because it distorts production and consumption patterns

²⁷ Song, Y. 2003, 'Korea: shifting to market-oriented principles' in Centre for International Economics 2003, *Magellan Project, The Political Economy of Beef Liberalisation: A Collection of International Papers*, Prepared for the Five Nations Beef Group, Canberra, p. 118–39.

1 Agricultural PSEs for the OECD, the United States, Japan and the European Union

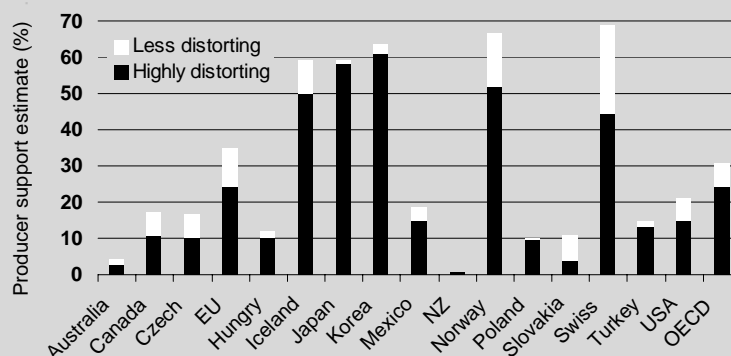


Data source: OECD 2002, *Agricultural Policies in OECD Countries: Monitoring and Evaluation*, CD-Rom, Paris.

for agricultural commodities. It is the *disparities* between assistance given to different industries across countries, as well as the type of assistance, that create relative incentives for producers and consumers to switch their production and consumption decisions one way or another (chart 2 shows that most policies are highly distorting). The issue is not how average protection for agriculture has moved over time; it is how the disparities between those industries that are highly protected and those that are not protected have moved. And it is not just the disparities between agricultural industries that matter. The disparities between agriculture and non-agricultural industries, and the disparities between countries also matter.

The data on disparities is not good. For some industries, for example beef production in the European Community, the average PSE as measured by the OECD has risen since the implementation of the Uruguay Round in 1996. Without a proper economy-wide analysis, the world cannot

2 The mix of highly distorting and less distorting agricultural subsidies in OECD countries, 2001



Data source: OECD, *Agricultural Policies in OECD Countries: Monitoring and Evaluation*, Paris, 2002, p.158.

know today whether the real cost of agricultural protection has gone up or down. This is a major deficiency in the work of the OECD and needs correcting. Certainly, cursory examination of both apparent disparity changes in the PSE's between different agricultural industries and the change in support for agriculture versus non-agriculture indicates the economic costs of agricultural support in OECD countries may well have gone up since the end of the Uruguay Round.

The anomalies and contradictions in the GATT/WTO system's treatment of agriculture compared to manufacturing are a deep-seated problem. In manufacturing, for example, export subsidies and the use of quotas are banned. Although the mandate of the Doha Declaration calls for the 'eventual elimination of export subsidies', the compromise text advanced by the European Union²⁸ and the United States just ahead of the ministerial meeting in

²⁸ *Washington Trade Daily* 2003, 'US, EU offer agriculture negotiating framework', vol. 12, no. 162, 14 August.

Cancun, clearly envisaged an ongoing role for export subsidies in agriculture. Yet both the European Community and the United States rail hard against anti-dumping. Both are quick to initiate dumping actions within the WTO system. But, by definition, export subsidies are blatant dumping. The European Community and the United States, the two largest players in the WTO, are on the one hand arguing for dumping to cease and on the other hand are arguing that dumping should continue! No wonder there is a cynical belief among some developing countries that the WTO is a 'rich man's club'.

The high support for agriculture in OECD economies has two effects. It has a high cost on the domestic economies of those countries offering protection for agriculture. It also has a high cost on those countries potentially exporting agricultural products to the OECD economies.

Problem for the poor

Some countries, such as Argentina, rely highly on agricultural exports for their foreign exchange earnings. Around half of Argentina's foreign exchange earnings come from agricultural exports, and it has a comparative advantage in agricultural production. But Argentina is not allowed to be fully effective and exploit this comparative advantage because it has only limited access to global markets for the things it is good at producing.

Imagine then Argentina's views towards the WTO and the rich countries that distort world agricultural trade. In the words of Guido Di Tella, Argentina's Minister of Foreign Affairs, at the failed attempt to launch a round of trade talks in Seattle in 1999, 'let me assure you that, if agriculture remains an unsolved issue after the future multilateral trade negotiations, this will not become a minor commercial or systemic point. Think politically. Do you believe that the

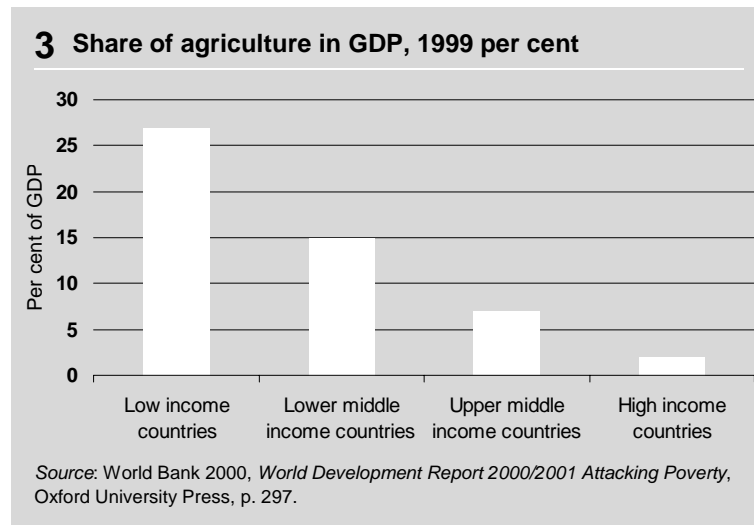
WTO can go ahead showing that it still has a rich man's club agenda? Do the main partners want to consolidate the WTO or has it become an actual burden for their policy making?"²⁹

By treating agriculture as a special case it has become a 'special case'. The exemptions and subsequent developments under the GATT/WTO system are important because agriculture is one of the largest sectors in many developing economies. For many developing countries, agriculture is the dominant employer of the work force, as well as the major source of foreign exchange earnings and one of the largest contributors to gross domestic product (see chart 3). Decisions on agriculture have an enormous impact on the economic performance of many countries.

Protection for agriculture is greatest in the rich industrialised economies, particularly the United States, the European Community, Japan and other Nordic economies. The series of exemptions has allowed powerful farm lobby groups to become well-entrenched in rich countries. That, combined with the decline in relative importance of agriculture in these countries, has increasingly left decisions to agricultural ministers who are part of the problem. The special treatment for agriculture can lead to cynicism among developing countries that the GATT rules are selectively applied in the interest of the rich economies.

Analysis conducted on the Uruguay Round shows developing countries, such as Argentina, were 'dudged' last

²⁹ Di Tella, G. 1999, 'The leadership and institutional challenge in an integrating world economy', in Stoeckel, A. and Corbet, H. (eds), *Reason versus Emotion: Requirements for a Successful WTO Round, Seattle 1999*, RIRDC Publication No. 99/167, Canberra, p. 28.



time.³⁰ They are unlikely to allow another weak outcome on liberalisation of agricultural trade this time as happened under the Uruguay Round. Unless there is more progress here, many developing countries — not to mention the Cairns Group of agricultural exporting countries — will increasingly look at the WTO system with greater cynicism and suspicion that it is not really working in their interests. If the commitment to the WTO by a large block of countries falters, respect for, and therefore compliance to, the rules governing international trade weakens.

In the immediate term, there is also the prospect that, without agreement on agriculture, there will be no further agreement in the Doha round of trade talks. The Doha round of talks is a 'single undertaking', meaning there will be agreement on nothing until everything is agreed. The conclusion is clear: continuing to exempt agriculture from the strong disciplines of GATT law will prove a major corrosive force for the international trading system.

³⁰ Finger, J.M. and Nogués, J.J. 2002, 'The unbalanced Uruguay Round outcome: the new areas in future WTO negotiations', *The World Economy*, vol. 25, issue 3.

Solving the problem

Another weak outcome on liberalising agricultural trade, this time as part of the Doha round of trade talks, will be a major termite for the WTO system. Farmers in many parts of the world will continue to be discriminated against — yet one of the most powerful principles of the GATT/WTO system is that of non-discrimination. This principle is one of the few ideas that make economic sense in the GATT rules — non-discrimination leads to fewer distortions in the decisions by producers and consumers about what they buy and sell.

Solving the agricultural problem will be difficult — after all, it has eluded policy makers for fifty years. Everyone knows the problem is political: the farmers in highly protected markets are vocal and well organised, while the beneficiaries of liberalising agricultural trade are widely dispersed. However, few studies take the diagnosis of this problem further and examine what can be done about it. One study³¹ examined where the political forces for liberalisation might come from, observing that there are powerful political forces serving to keep agricultural protection in place. Logically, reform will come when more powerful political forces in favour of liberalisation are brought to bear on this issue.

Looking at the problem this way brings to light the many political groups with an interest in liberalising world agricultural trade. For one, consumers in the protected markets could have greater access to better-value-for-money products. Second, taxpayers in the protected markets would save a fortune by removing subsidies paid to farmers out of government budgets. Other interest groups are developing

³¹ Stoeckel, A. 2000, *Solving the Problem: A Look at the Political Economy of Agricultural Reform*, prepared for the Cairns Group Farm Leaders Meeting, Banff, RIRDC Publication No. 00/124, Canberra.

countries and agricultural exporters, particularly the Cairns Group. Clearly, these groups would be gainers with greater access to protected markets.

The manufacturers and other exporters within the protected markets are yet another group standing to gain. As economists know only too well, but most negotiators seem not to, the burden of protection for agriculture in protected markets is borne by the export sectors of the economy of the country protecting its agriculture from imports. In Japan, Europe and America these exporters are in the manufacturing and services sectors. By protecting agriculture, the costs in other sectors such as manufacturing and services are higher than need be, so sales are lost on export markets. Exporting sectors bear the brunt of the burden of agricultural protection.

Yet another group interested in solving the agricultural problem is the green movement. Some 80 per cent of agricultural subsidies are perverse — that is, they damage both the economy of the country providing the subsidies and the environment.³² The green movement has a powerful incentive to eliminate most agricultural subsidies.

The final interest group is the one identified in this study: the international community that wants to see a strong, open, rules-based multilateral trading system. Unless solved, the combination of the agricultural trade problem with the other termites identified in this study will eventually collapse the WTO system.

Although each one of these coalitions can be identified, Stoeckel's study³³ found that each one of these interests on their own was not powerful enough to reform agricultural

³² Humphreys, J., van Bueren, M. and Stoeckel, A. 2003, *Greening Farm Subsidies: The Next Step in Removing Perverse Farm Subsidies*, RIRDC Publication No. 03/040, Canberra.

³³ Stoeckel 2000.

protection. The strong conclusion was that liberalisation of world agricultural trade would only occur when several of these interest groups joined forces in reforming world agricultural trade. This is yet to happen.

The problem with the Doha round of trade talks is that it appeals to only one of the above groups with an interest in reforming world trade. This group consists of the exporters of goods and services who face barriers to the things they sell in foreign markets. A multilateral round of trade talks is based on the fundamental principle of reciprocity. 'Concessions', such as the reduction of agricultural support, are 'traded' for something of more-or-less equal value to the country offering the concession. So the interests of protected farmers, who do not want to see concessions, is traded off by negotiators who want greater access to someone else's market for their exports (or something else of value). Reciprocity pits the interests of exporters facing barriers to trade against those wanting protection from imports.

At least that is how it has worked in the past. But two points here: things have changed and there is a major logical flaw in the notion of reciprocity. The change is that the natural political coalition of interests to argue for removal of agricultural protection is no longer there — especially in Europe and Japan. The logical flaw is that 'concessions' are not valuable at all. The barriers being traded away mostly hurt the country imposing them. This mercantilist thinking has been known to be wrong for a long time. Adam Smith and David Ricardo exposed this wrong 'exports good, imports bad' mentality.

The point to note here is that the Doha round of trade talks brings only one interest group into the political equation — exporters who face barriers in other markets. And this group's political incentive to argue for change has weakened over time with success in reducing barriers to trade in

manufacturing and services in the markets that matter. Therefore, to see liberalisation, a coalition with sufficient power to outweigh the interests of protected farmers has to be brought into the political equation. Mostly these groups do not form now because the effects of protection are hidden and the analysis of the 'unseen' is rarely done. The best way to identify who bears the burden of protection is economy-wide analysis of the benefits and costs of protection. This analysis has to be conducted through an open, transparent process. Such a process changes the politics of protection.

This point about economy-wide analysis and transparency to repair other deficiencies in the WTO system is a recurring theme throughout this study. Since it is so important and common to other issues, it is elaborated on in the final chapter. Now it is necessary to return to the issue of reciprocity.

4 RECIPROCITY

Reciprocity is a basic principle of the WTO system. It is a mechanism used in multilateral trade negotiations to either liberalise markets or agree to new or changed rules.

Reciprocity is a bargaining tool. At its simplest level, it may involve a tariff reduction for a good like steel in exchange for another country's offer to reduce tariffs on, say, textiles. But the bargain can be for anything of perceived value to a WTO member, including non-trade concerns, and need not be simultaneous in time. Bhagwati highlights several typologies that can be used to classify reciprocity — for example, whether it is 'simultaneous' or 'sequential', or 'within trade' or 'outside trade'.³⁴

Reciprocity has three advantages, discussed below. First, it changes the political dynamic, facilitating liberalisation. A second advantage is its basic appeal to 'fairness' —every member is seen to be contributing to liberalisation. The third advantage is that the reciprocity mechanism can overcome the 'free-rider' problem, which is inherent in any multilateral trade negotiation because of the unconditional MFN principle. Despite these advantages, reciprocity also has some drawbacks that are now holding the cause of trade liberalisation back.

³⁴ Bhagwati, J. 2002, *Going Alone: The Case for Relaxed Reciprocity in Freeing Trade*, MIT Press, London, p. 10.

Political dynamics

Reciprocity changes the political dynamic of liberalisation. Protection against imports persists because those who stand to gain from preventing imports into a country, namely the producers of the competing product, form effective lobby groups asking for protection. They point to the extra activity in their industry and the extra jobs that protection creates. All of that is true for *their* industry. All too often politicians and the public go along with this simple argument, believing ‘imports cost jobs’. This belief looks obvious, but turns out to be wrong.

Just why this belief is wrong is well known to economists. Since it goes to the heart of one of the termites eroding the foundations of the GATT/WTO system, it is fully explained later in this chapter. For now it is sufficient to note, whatever the reason, real or imaginary, that negotiators believe that, during multilateral trade negotiations, they are offering up a ‘concession’ in exchange for access (or something else of value) to another country’s market. By tying the access to another country’s markets (which, correctly, is of benefit) in exchange for removing a tariff on imports at home (the ‘concession’), powerful political forces are brought into play. The interests of the exporters who stand to gain are pitted against the interests of producers in import-protected industries who resist liberalisation. The ‘jobs will be lost’ argument made by local producers competing with imports is offset by the local exporters’ argument that ‘jobs will be created’.

Reciprocity therefore changes the political balance and makes liberalisation more politically possible. An added bonus is that if everyone liberalises together, the gains are greater and the adjustment costs smaller.

Fairness

The second advantage of reciprocity is also political. Everyone 'conceding' lower barriers together appeals to people's sense of fairness. Fairness is a major political force and partly lies behind the emphasis on developing countries in the Doha Round of trade talks, officially called the Doha Development Agenda. The emphasis on developing countries in these negotiations is warranted because they received an unfavourable outcome on many issues important to them, including agriculture, in the Uruguay Round.

Partly, developing countries dealt themselves out of a good deal on agriculture because they were exempted from reciprocity. Rich countries, denied reciprocal concessions from poor countries, concentrated on liberalising trade in products of interest to themselves.³⁵ Unfortunately, one mechanism tailored to help developing countries, namely preferential access, is causing problems of its own. This is the subject of chapter 9. For now, it is enough to note that 'fairness', whether used correctly or incorrectly,³⁶ is an important political consideration and reciprocity appeals to this.

Free riders

The third rationale for reciprocity is that it helps prevent the free rider problem. Because of the unconditional MFN principle in the multilateral trading system, a WTO member could sit back in a multilateral trade negotiation and cheer everyone on to liberalise. Then, under the MFN principle, they could avail themselves of the most favourable terms of

³⁵ Bhagwati, J. 2002, 'The poor's best hope', *The Economist*, 22 June, p. 25.

³⁶ 'Fairness' is an abused word and can be code for 'justifiable' protectionism in the rich countries, as Bhagwati notes in, *Going Alone: The Case for Relaxed Reciprocity in Freeing Trade*, MIT Press, London, p. 29, footnote 25.

access offered to any other country. Of course, nothing would happen if every member did this. The principle of reciprocity ensures that by moral suasion at least all countries more or less participate in offering concessions.

Note the difference between unconditional and conditional MFN here. Under conditional MFN, bilateral tariff reductions to third nations are not automatically extended.³⁷ Rather, it is presumed the concessions will be extended to third parties only if they too make acceptable reciprocal trade concessions. The GATS favoured this approach by including an annex allowing countries to invoke an exemption to MFN³⁸, unlike the GATT. Bhagwati describes how conditional MFN ensures reciprocity between any pair of nations, eliminating the 'free-rider' problem.³⁹

What is wrong with reciprocity?

Whatever the reason for reciprocity, there is no doubt that if all countries liberalise together, the gains are greater and the adjustment costs smaller. Multilateral liberalisation of trade should be an easy matter, politically popular and problem areas such as agriculture should not exist. Unfortunately, this is not the case.

Reciprocity is not working now as a major force for liberalisation, including for agriculture, for two reasons. One is that reciprocity is a dangerous political game because it sends out the wrong message about trade liberal-

³⁷ Bhagwati, J. 2002, *Going Alone: The Case for Relaxed Reciprocity in Freeing Trade*, MIT Press, London, p. 12.

³⁸ MFN exemptions were time-bound and subject to negotiation in future rounds of trade talks. A good discussion of MFN and national treatment in GATS is contained in Hoekman, B. 1995, 'Assessing the General Agreement on Trade in Services', in Martin, W. and Winters, L.A. (eds), *The Uruguay Round and the Developing Economies*, World Bank Discussion Paper 307, Washington DC.

³⁹ Bhagwati 2002, p. 13.

isation. The other reason is that the political forces that could be brought into play to help secure liberalisation are now no longer there. No natural constituency currently exists in the European Union or the United States to argue against the interests of the farmers who receive so much protection.

That reciprocity makes good politics, but lousy economics, has been well known for some time. As put simply in the study by Viravan and others in the late eighties, 'the emphasis on reciprocity misinforms and miseducates everyone (including trade officials) about the basic argument for liberal trade'.⁴⁰ The problem is that reciprocity sets up a game scored by mercantilist rules: an increase in exports is a victory, but an increase in imports is a defeat.⁴¹ Reciprocity fuels the 'exports good, imports bad', message that is dead wrong. If the public wrongly believes imports are bad, politicians will find it that much harder to liberalise trade.

Why is the 'imports bad' message wrong? Quite apart from the simple math that no one could export if there were no imports, the 'imports bad' message ignores basic economics and the basis for trade. It pays to trade because countries have differences in their comparative advantage for producing different things. That is, some countries are relatively better at using their resources to produce some things over others. By concentrating on exporting the things each country is relatively good at producing, it is possible for both parties to exchange to become better off. And, by importing the things they are less good at producing, resources are freed up for use in the industries they *are* good at — the export industries. In this way, the welfare of both parties to the exchange is improved.

⁴⁰ Viravan, A., 1987, *Trade Routes to Sustained Economic Growth: Report of a Study Group of the Trade Policy Research Group*, MacMillan Press for the United Nations, London, p. 136.

⁴¹ Krugman 1997, pp. 113–20.

Imports add to welfare because they allow a country to concentrate on what it does best. Exports are a good thing, but *only* because they allow a country to earn the foreign exchange with which to purchase imports. While saving some foreign exchange for future use might be nice, to deny its use forever simply makes the foreign exchange worthless; it would be like being marooned on a desert island with a bucket of gold.⁴² Indeed, should a country stop all imports, eventually all exports would stop too — so an import tax (barrier) simply ends up being an export tax.

In summary, imports are good because they add to welfare and allow a country to specialise in its exports. The successful exporting countries around the world are those that are successful at importing. The increase in imports from trade liberalisation is therefore a benefit, not a cost. This major misunderstanding about the basis for trade is fuelled by the principle of reciprocity. With such flawed thinking, it is little wonder there is only minimal public support for liberalising trade. Playing clever politics around an economically flawed concept may have worked in the past, but it has now set the cause of free trade backwards. That drawback is exacerbated by reciprocity's second weakness.

The second problem with reciprocity is that it has outlived its usefulness. This was recognised as a potential problem before the Uruguay Round really got under way, and it is even more apparent now.⁴³

Reciprocal bargaining has failed to obtain any worthwhile liberalisation for agriculture — indeed, for some industries such as beef, OECD figures show *increased* protection since

⁴² Stoeckel, A., Vincent D. and Cuthbertson, S. 1989 (eds), *Macroeconomic Consequences of Farm Support Policies*, Duke University Press, p. 19.

⁴³ Viravan 1987, p. 137.

the end of the Uruguay Round.⁴⁴ Agriculture is left as the standout issue in goods and services trade — earlier trade talks focused on manufactures, including (belatedly) textiles, and more recently in the Uruguay Round on services trade. However economically flawed the concept, if reciprocity is to work, it must pit some interest groups within the European Union, the United States or Japan against their farmers receiving protection. But there is little else left to liberalise from the European Union's and the United State's points of view — the simple average tariff on industrial products in the United States is 4.7 per cent. In the Europe Union it is 4.5 per cent. Although tariffs are higher in developing countries, these are not major markets for Europe or the United States.

If there is not much to offer on trade liberalisation in goods and services, could other non-trade concerns be 'conceded'? The four so-called 'Singapore issues' of investment, competition policy, transparency in government procurement and trade facilitation are of interest to the Europeans. However, as explained later in chapter 9, formally including these issues in the WTO system is not necessarily a step forward. Even if Singapore issues were formally included, there is no domestic political group in the European Union to argue in favour of including them in return for the removal of agricultural support. There is no natural constituency for these issues, quite unlike a simple exchange of 'concessions' by the European Union on, say, sugar imports for greater access to world automobile markets. In the past, export industries such as the car industry would have lobbied for concessions on something like sugar because greater access to another market would affect their bottom line. But better competition policy rules? The link to an

⁴⁴ Stoeckel, A. 2003, *The Political Economy of Beef Liberalisation: A Collection of International Papers*, Prepared for the Five Nations Beef Group, Canberra, p. xvii, chart 2.

improved bottom line for a firm or an industry is very indirect and some would even argue the sign of the effect. The natural groupings are no longer there.

Relying on reciprocity now to secure liberalisation of agriculture is not likely to work. Simply, there is not enough in the deal for major players such as the European Union. On top of that, the very notion of reciprocity has mis-educated generations of people into thinking that imports are bad and to be resisted. One glimmer of hope is the emergence of a new grouping of people arguing for liberalisation — namely, everyone who wants to see a prosperous, well working, open multilateral trading system. For without liberalisation of sensitive areas such as agriculture, and repair work on the other deficiencies in the WTO system, it will eventually fail.

The antidote to lousy economics under reciprocity is good economics. This should be introduced via the changes to the TPRM discussed in chapter 10. The problem of ‘nothing left of value’ to trade is to add a fifth Singapore issue — going back to first principles and devising a clear, coherent and consistent set of rules that will lead to an open multilateral trading system. Implementing such a ‘fifth Singapore issue’ would ensure the long term survival of the WTO system.

5 DISPUTE SETTLEMENT AND ENFORCEMENT OF RULES

Every club has rules governing the behaviour of its members. So it is for the smooth functioning of the world trading system. When rules are broken there must also be mechanisms to settle any disputes between members and to allow for the means, such as sanctions, to enforce compliance with those rules.

One of the innovations of the Uruguay Round was to strengthen dispute settlement procedures under the WTO. But problems and weaknesses in this system remain. Different researchers attribute varying degrees of concern to how big a problem these weaknesses could be.

The major strength of the dispute settlement system under the WTO is that it is more timely, automatic and binding than under the GATT.⁴⁵ Under the GATT system it was possible for one of the parties to dispute or block the establishment or adoption of a panel. Uruguay Round innovations increased the opportunities for arbitration, introduced time limits for the various stages of panel proceedings, standardised terms of reference for panel, and improved surveillance of the implementation of panel reports.⁴⁶ Panel

⁴⁵ Hoekman and Kostecki 1995, p. 46.

⁴⁶ Hoekman and Kostecki 1995, p. 46.

reports can still be blocked under the WTO, but this is highly unlikely as it may only be done by consensus.

The process of dispute settlement is reasonably straightforward.⁴⁷ The process includes an initial mediation phase to try and solve the dispute bilaterally. If this fails, a panel may be set up within 60 days to adjudicate the case. The operation of this panel is standard: facts are collected, meetings are held where cases and rebuttals are made, more meetings are held and more submissions are collected if needed, an interim report is prepared, conclusions and recommendations are drafted and the panel's final report is submitted to the parties.

There is then an appeal avenue to the standing Appellate Body, another Uruguay Round initiative. If the Appellate Body concurs with the panel report, the member affected must implement the report's recommendations or pay compensation.⁴⁸

If the member fails either to implement the panel report or offer adequate compensation to the winning party, the latter may take retaliatory measures as authorised by the Dispute Settlement Body. The problem of enforcing of the rules through sanctions is handled later in this chapter — it is the third deficiency in the safeguard agreement. The other two deficiencies are the incentives to abuse the safeguard rules and the tendency for the Dispute Settlement Body to become a lawmaker rather than a law-interpreter.

Incentive to apply safeguards

In March 2002 the United States imposed tariffs and tariff quotas on steel imports, on the grounds that these imports were a substantial cause of serious injury to the domestic

⁴⁷ A good description of this process is in Hoekman and Kostecki 1995, p. 47.

⁴⁸ Hoekman and Kostecki 1995, p. 48.

industry. A successful challenge by the EU in the WTO saw the safeguard action terminated by executive order on 5 December 2003. This example, and other successful challenges to safeguard action by the United States (notably for line pipe, lamb and wheat gluten), are held up as a process that is working well and limiting protection action.

But these cases also highlight a flaw in the safeguard agreement. There is an incentive to abuse safeguard rules. As Lawrence and Stankard⁴⁹ argue, 'the Safeguards Agreement grants national authorities considerable berth to interpret the standards in a manner favorable to domestic industry. Since WTO review only occurs after a safeguard is imposed, and since disputed measures must go through a lengthy process of investigation and appeal, the current system provides an incentive to protect now and deal with the repercussions later. George W. Bush knew, for example, that even if his steel measures violated the rules, he could get away with them for almost two years before they would be found illegal by the WTO'. Evidence of this is that in five out of the six times the United States has imposed safeguards over the last decade, they have been successfully challenged by affected trading partners.⁵⁰ Part of the answer seems to lie in speeding up dispute resolution, but Lawrence and Stankard also point to differences between the laws and interpretation of those laws by the United States International Trade Commission and the WTO. That introduces the second issue, that the Dispute Settlement Body can become the lawmaker rather than a law-interpreter.

⁴⁹ Lawrence, R.Z. and Stankard, N. 2004, 'America's sorry trade performance', *The International Economy*, Winter 2004, p. 35.

⁵⁰ Lawrence and Stankard 2004, p. 36.

WTO as lawmaker

This unintended role for the WTO occurs via two paths. The first is the way trade disputes are settled — either by agreement or by a panel ruling. Trade disputes are often solved by mutual agreement. But any mutually agreed settlement necessarily involves a large dose of politics, leading to inconsistencies in outcomes between similar disputes. Similarly, panels develop a body of case law for international trade disputes. Although these precedents are not technically binding due to the absence of the *stare decisis* doctrine in international trade law, there is *de facto stare decisis* as parties draw upon the voluminous work and arguments made in previous decisions when the outcome of the past case supports their point of view. The danger here is that ‘bad law’ created by a panel can be solidified and perpetuated in the future.⁵¹

The second way by which the Dispute Settlement Body becomes a lawmaker is identified by Barfield.⁵² It revolves around the logic of international law, its formation, and the speed with which disputes can be settled. Barfield argues the new ‘judicialised’ WTO dispute settlement system is substantively and politically unsustainable because there is no real consensus among WTO members on many of the complex regulatory issues that the panels and Appellate Body will be asked to rule upon.⁵³

The problem goes back to the basis of international law and the timeframe required to make such laws. Because there is no enforcement arm of the WTO, enforcement of international trade rules relies on agreement between the members of the club. Members join this club because it is

⁵¹ Hoekman and Kostecki 1995.

⁵² Barfield, C.E. 2001, *Free Trade, Sovereignty, Democracy: The Future of the World Trade Organization*, Washington DC, p. 7.

⁵³ Barfield 2001, p. 7.

to their benefit to have governments abide by a common and authoritative system of rules. But there is a vast array of views amongst the 148 members about regulation and the underlying economic system, and the rules are only effective if countries agree to them. This situation is quite unlike enforcing rules in a sovereign country through the police force and where the rules themselves can be challenged in the court system. International rule making involves considerable diplomacy. As already outlined in chapter 2, making rules by consensus diplomacy necessarily involves ambiguities and language that is deliberately chosen so members can agree on the text. This is quite apart from any contradictions and inconsistencies in the existing GATT articles themselves. So, many of the dispute settlement system's cases are, or will be, brought to clarify these ambiguities. In the clarification process the Dispute Settlement Body 'creates law'. And this, in Barfield's view, raises intractable questions of democratic legitimacy.

One of the causes of this problem is that international rule making takes time, whereas the dispute settlement system is much quicker because it is time-bound and designed to lead to a conclusion. Barfield's solution to this problem is for more 'diplomatic' flexibility and greater resort to conciliation, mediation and voluntary arbitration.⁵⁴ If a substantial minority of WTO members oppose a decision, a blocking mechanism could be used to set that decision aside until a consensus is reached by negotiation. As part of the problem of inconsistent terms and ambiguous language stems from the original GATT, where, as Tumlrir notes, the case for free trade was never fully made,⁵⁵ this will also need to be rectified.

⁵⁴ Barfield 2001, p. 7.

⁵⁵ Tumlrir 1987.

Enforcement

The third problem with dispute settlement is enforcement. There is no obligation for an offending member to withdraw a measure that violates the WTO agreement. The only two options available are compensation and retaliation. Compensation, either through fines or trade liberalisation measures offsetting the effects of the violation, is far preferable to retaliation.⁵⁶ The problem with retaliation is the same as with reciprocity — retaliating against a country by imposing tariff barriers on imports imposes an additional cost on one's self. In the popular phrase it implies 'shooting one's self in the foot'.⁵⁷ Most small countries, therefore, cannot afford to retaliate even if they do win in a dispute where the offending party does not undertake remedial action. And yet one purpose of the WTO was to apply the rule of law to trade policies in order to look after the small and weak countries against the strong and powerful. More emphasis on compensation, as Barfield advocates, is one answer.⁵⁸ Another, suggested by Hoekman and Kostecki, is that retaliation could be by all members, not just those affected. The banana case is a classic example in how the dispute settlement system does not work well. It also highlights the lack of transparency and public education of what the real trade problem is and where the best solution lies (see box 4).

Costs of dispute settlement

Another issue with dispute settlement and subsequent appeals is the high cost. Many developing countries have

⁵⁶ Barfield 2001, p.7.

⁵⁷ Hoekman and Kostecki 1995, p. 48.

⁵⁸ Barfield 2001, p. 130.

4 Banana wars

When people mention 'bananas' they often laugh. But bananas are big business — they are one of the most valuable horticultural products traded in the world today. The banana dispute in the GATT/WTO dragged on for eight years and may not yet be over if the European Union puts in place higher tariffs after 2006 — which it appears set on doing. Even though the dispute went on for so long and still remains up in the air, some writers, notably those in a volume edited by Josling and Taylor,^a appear to legitimise rather than criticise the extravagant inefficiencies of the dispute settlement process. By providing a complex blow-by-blow account of the dispute, regrettably they (unwittingly) obfuscate the fact that the banana dispute really revolved around a simple issue (bad policy) with a simple solution (trade liberalisation) — much of which was well known in the early 1990s. It became complex, costly, legalistic and obscure because the dispute settlement process is based on unsound rules and does not focus on the desired economic outcome.

The analysis of the banana case by Borrell^b is at odds with the much larger study by Josling and Taylor. Borrell's analysis is highly critical of the process and concentrates on the economics of the issue, including the economy-wide effects, whereas the Josling and Taylor study focuses on the dispute settlement process. The process is naturally an antagonistic, lose-lose situation. At no stage in the eight years did the European Commission say 'This policy is wrong' (which it is) and 'The banana market should be liberalised' (which it should be). To get to this point requires more emphasis on economy-wide analysis of costs and benefits, and of the alternative policies as part of the process of dispute settlement.

^a Josling, T.B and Taylor, T.G. (eds) 2003, *Banana Wars, The Anatomy of a Trade Dispute*, Cambridge, USA.

^b Borrell, B. 1999. Bananas: straightening out bent ideas on trade as aid', paper prepared for The World Bank's Integrated Program of Research and Capacity Building, presented at The Conference on Agriculture and The New Trade Agenda in the WTO 2000 Negotiations, Geneva, Switzerland, October 1-2.

only limited capacity to deal with these issues. A high-cost legalised system confers advantages to large countries with greater resources and access to trade lawyers. As it stands,

the burden of cost and responsibility of undertaking disciplinary action resides with the exporter. The importing or home country should bear these disciplinary costs as it may help discourage trade restrictions. Of course, the importing country bears most of the economic cost of restricting trade, so effective transparency is also a powerful weapon in discouraging restrictive trade practices in the first place and in facilitating good decisions from the dispute settlement process.

There are other issues and recommendations surrounding the Safeguards Agreement. The purpose has not been a comprehensive review of safeguards, rather to highlight several things. First, safeguards are a reality of international agreements as they allow governments to sign up to often contentious liberalisations. They also allow governments room to maneuver in politically sensitive areas without jeopardising a whole agreement. But the system is not working well. Contrary to cases such as the recent US steel decision showing the system is working, it is more likely that the system encouraged the almost two years of steel sanctions. Sanctions should not have been imposed in the first place.

Next is the increasing reliance on legalism and de-emphasis on economy-wide cost-benefit analysis that at least encourages win-win mediated outcomes by highlighting who really bears the burden of protection. Third, is the flaws in the dispute settlement dealt with here.

In summary, the dispute settlement process of the WTO was substantially improved as a result of the Uruguay Round. But it still has flaws, which, left unchecked, are likely to erode the commitment by some countries to the WTO. One flaw is that the time taken for disputes to be actioned can be around two years and creates an incentive to abuse the rules. Another flaw is the tension between the ambiguous rules set diplomatically by a voluntary club of

disparate members, and the need for the dispute process to legally clarify those ambiguities at a greater pace than diplomacy will allow for the rules to change. The third flaw is that enforcement of rules often involves sanctions by the complainant member so they lose twice over. Several remedies have been advanced to deal with this and all are worthy of scrutiny by the expert group elaborated on in chapter 10.

The easiest way to remove the excessive reliance on legalism and the win-lose mentality of the dispute settlement process is to conduct a formal cost-benefit analysis allowing for all secondary effects of the contentious issue. This analysis must be fully transparent. Since the economics of trade is win-win, cost-benefit analysis focusing on the economics of the issue under dispute will encourage mediated outcomes benefiting both parties, thereby potentially avoiding costly trade wars and saving on legal costs.

6 PREFERENCES AND DEVELOPING COUNTRIES

The plight of developing countries and the persistence of poverty is one of the great moral and economic issues of the modern era. However, a potentially damaging trend in the WTO is the increased emphasis on special provisions afforded to developing countries, even though this preferential treatment is well intended.

It is right to give priority to trade issues for developing countries because it is well established that globalisation with increased trade is one of the important ingredients needed for a country to successfully lift its average level of income and reduce its poverty.⁵⁹ Indeed, the Doha round of trade talks is officially labelled the 'Doha Development Agenda'. Yet somehow part of this concern for developing countries has become distorted and the debate on special provisions for developing countries has gone awry. The most damaging part of all is preferential access.

Preferential access is granted for developing countries exporting to rich markets. Some developing countries can sell, say, sugar or bananas to the European Union on more

⁵⁹ Recall earlier analysis by the World Bank (see footnote 2) showed free trade would lift 320 million people out of poverty. Also see Centre for International Economics (with the assistance of AusAID, the Department of Foreign Affairs and Trade and the Department of Treasury) 2001, *Globalisation and Poverty: Turning the Corner*, Canberra.

favourable terms than other countries. The idea looks simple and obvious, and it appeals to popular, modern, political sensibilities. But when all other secondary and unseen effects are incorporated, the opposite is more likely to be the case — that is, preferential access is *not* in the best interests of developing countries. As this conclusion will sit uncomfortably with many readers, it is necessary to spell it out carefully. Understanding what is wrong with preferential access and how this arose requires an appreciation of some subtle and complex nuances of the world trading system and a revisitation of one of the GATT's main pillars — Article I, the MFN principle covering the issue of non-discrimination.

First, it is necessary to briefly backtrack and explain how part of the special provisions for developing countries has ended up being one of the major termites now eroding the foundations of the WTO system. Special provisions to developing countries under the WTO system fall into two classes: special and differential treatment, and preferential market access.

Special and differential treatment

Special and differential treatment simply means leniency for developing countries. Developing countries have smaller commitments or longer transition periods to implement WTO agreements compared to developed countries.⁶⁰ For example, under the Uruguay Round Agreement on Agriculture, the average cut in tariffs for developed countries was 36 per cent, to be made over six years. For developing countries, the average cut in tariffs was 24 per cent over ten years, except for the least developed countries, which were not required to cut tariffs at all.

⁶⁰ Stoeckel, A. and Borrell, B. 2001, *Preferential Trade and Developing Countries: Bad Aid, Bad Trade*, RIRDC Publication No. 01/116, Canberra.

Other areas of special and differential treatment for developing countries include technology transfer under intellectual property protection. The GATS also allows developing countries some preferential treatment. Altogether, the WTO Agreements contain over 100 provisions giving developing countries special treatment.⁶¹

Some of this special treatment for developing countries is warranted. One basis is that these countries have less capacity to implement WTO Agreements within a certain time period. Another basis is that they have a lower degree of sophistication in appropriate adjustment schemes to handle the resource reallocation decisions flowing from implementing trade liberalisation agreements. Sometimes too, developing countries rely on tariff revenue as an important source of government financing. If this is lost, the less sophisticated tax system in many developing countries can help precipitate an enormous hole in the government accounts. It takes time to replace this loss of tariff revenue with other instruments.

But, for all its benefits, special treatment for developing countries creates problems too. By not requiring developing countries to reciprocate with trade concessions, they have dealt themselves out of their liberalisation gains. As Bhagwati notes of previous Rounds, 'the rich countries, denied reciprocal concessions from the poor countries, wound up concentrating on liberalising trade in products of interest largely to themselves, such as machinery, chemicals, and manufacturing rather than textiles and clothing'.⁶² Exempting developing countries from fully participating in trade rounds has not, in fact, been in their own interests.

⁶¹ Stoeckel and Borrell 2001, p. 3.

⁶² Bhagwati, J. 2002, 'The poor's best hope', *The Economist*, 22 June, pp. 25–6.

Preferential access

Preferential access is a far more serious issue for the cause of free trade and the benefits that flow than special and differential treatment. Preferential access is granted by many OECD countries to developing countries. Preferential access can take many forms. One common form allows countries to waive WTO rules and set up non-generalised preference schemes. Examples include non-reciprocal preferential agreements such as the US-ANDIAN Trade Preference Act and the CARIBCAN Agreement, whereby Canada offers most Caribbean countries duty-free non-reciprocal access to its market. Under the Generalised System of Preferences (GSP), developed countries offer non-reciprocal preferential treatment to imports from developing countries. The GSP was introduced to the multilateral trade system in 1971 via a waiver, and obtained legal status in 1979 by an enabling clause in the GATT.⁶³ The GSP permits developed countries to bypass the MFN clause indefinitely by granting preferences to developing countries provided they are 'generalised, non-reciprocal, and non-discriminatory', though Stoeckel and Borrell⁶⁴ note increasing divergence from these three principles over time.

Yet these preference schemes are neither general, stable nor helpful. For example, the United States GSP scheme excluded textiles, clothing and footwear — the very things often of importance to developing countries. Further, Bhagwati emphasises the non-binding nature of the benefits granted, which can be varied at a rich country's displeasure.⁶⁵ He cites the example of India. Having included India on the special 301 list in 1991, the United

⁶³ Bhagwati, J. 2002, 'The poor's best hope', *The Economist*, 22 June, p. 26.

⁶⁴ Stoeckel and Borrell 2001.

⁶⁵ Bhagwati 2002, p. 26.

States trade representative unilaterally suspended these duty free privileges in 1992.

The Stoeckel and Borrell study also includes cases where preferences have actually been the 'kiss-of-death' for the recipient developing country.⁶⁶ Examples given are preferential access for sugar, in particular for Mauritius, and preferential access for bananas for African, Caribbean and Pacific countries. In the banana case, it was found that preferences actually divert trade away from other non-preferred developing countries. All that is happening is that one developing country has gained at the expense of another developing country. The study found that every dollar of aid going to one group of developing countries cost another group of developing countries an aid dollar. Net aid transferred to the world's poor was zero! Not only this, but the aid itself is needlessly expensive. In the banana case, the study estimated it was costing Europe \$13 to transfer \$1 of aid to the preferred developing country.

Little of the intended aid from preferences fulfils the goal of poverty alleviation because resources must be used to produce those goods that qualify for the aid. Mauritius is a particularly telling example of how the preference on sugar has encouraged wasteful use of resources, causing costs to rise and the sugar industry to become uncompetitive. Additionally, the economic rents created by the preferences end up in the hands of wholesalers and importers rather than the exporting country for whom they were intended as aid. The derivation of the above conclusion — that European Union sugar preferences were a 'kiss-of-death' for Mauritius — is important for the theme of this study, and is also elaborated in the final chapter. The conclusion was derived from economy-wide analysis. *All* effects — including the impact on land values, real wages and other

⁶⁶ Stoeckel and Borrell 2001, p. 34.

industries — were assessed along with the direct and obvious benefit of preferential sales of sugar to the European Union. When all direct and secondary effects were considered, the costs of preferential access outweighed the benefits.

Preferences also create perverse incentives. Think about the stance in the WTO of developing countries such as Mauritius on the issue of sugar liberalisation. Sugar is one of the world's most highly protected commodities traded in the world today. Mauritius and other developing countries receive preferential access in the European Union — one of those very highly protected markets. But if sugar is liberalised, Mauritius and the other preference receiving countries have a wasting asset. Their industries stand to face severe adjustment pressure if liberalisation of world sugar markets proceeds. These countries have an inherent vested interest to actually *oppose* further liberalisation of world sugar markets. Indeed, in the recent WTO challenge by Australia, Brazil and Thailand against the European Union's sugar policy, several third parties — of the likes of Mauritius and others who receive preferences — joined with the European Union in defending the existing arrangements.

Another problem with preferential access for developing countries is that this policy distracts from the main issue of economic development. Developing countries are now treating the WTO as an aid organisation. But the WTO was not set up to be an aid organisation, and it is not capable of being one. The problem is well illustrated by the example of liberalisation in the Philippines' economy. If the Philippines, hypothetically, unilaterally lifted all of its trade barriers, estimates are economic growth would rise by 7 per cent.⁶⁷ However, if the Philippines' trade liberalisation was

⁶⁷ Stoeckel, A., Tang, K.K. and McKibbin, W. 2000, *Productivity, Risk and the Gains from Trade Liberalisation*, Pelham Paper No. 9, Melbourne Business School.

part of a multilateral round of trade talks, economic growth would rise by nearly 8 per cent. Thus, some 90 per cent of the gains to the Philippines' economy from participating in a global multilateral round of trade reductions come from removing their *own* barriers. So when developing countries cry poor as a result of the actions of others, they divert attention from the real issues preventing development. It lets domestic politicians, who should be doing better, 'off the hook'.

The path to prosperity in developing countries lies mostly in tackling difficult domestic reforms such as secure property rights, the establishment of well-functioning financial and legal systems, better governance, open trade and investment, and better education. All of these actions are unilateral and not multilateral. Developing countries need to get their own house in order. Leaders of developing countries must be held accountable for the lack of development in poor countries. Those who perpetuate the belief that developing countries are worse off primarily because of a lack of market access to other markets, detract from the required emphasis on domestic reform and inadvertently weaken accountability of policymakers for the performance of their country.

The final thing wrong with preferences is that they are discriminatory. The cornerstone of the GATT — Article I — is the MFN or non-discrimination clause. It is the basis for an open, competitive system of world trade based on enforceable rules that benefit all nations, big and small. Preferential trade arrangements are discriminatory and weaken this cornerstone. They set a dangerous precedent and only help foster other preferential arrangements such as the formation of free trade areas under GATT Article XXIV. Today a high proportion of international trade is conducted on a discriminatory basis and disputes are

increasingly settled by discriminatory protection outside the GATT framework.⁶⁸

Without informed debate on this issue, things do not seem set to change in the near future. Bhagwati notes how rich countries still utilise the preferential 'trade as aid' route today. He cites the United States' introduction of the Africa Growth and Opportunity Act, which grants preferences for African garments to the American market. However, these preferences are tightly linked to reversed preferences for American fabrics. And these preferences all have to be administered through what can be costly rules of origin. This situation is not in the best interests of America, Africa or the world economy.⁶⁹

In summary, preferences for developing countries are dangerous because:

- they create rents, which are often captured by wholesalers and others instead of the intended beneficiary;
- they are a potentially wasting asset, with their value declining as further liberalisation proceeds;
- in some cases they are not an asset at all, but a liability — a 'kiss-of-death';
- they create a vested interest by the recipient country to actually block liberalisation of the product concerned in WTO trade talks;
- they weaken the cornerstone of the GATT — the MFN principle; and
- they lead to a system of managed trade.

Developing countries aspire to levels of economic activity and income equal to rich countries. The best way for this to happen is for rich countries to treat them equally and for

⁶⁸ Stoeckel and Borrell 2001, p. 45.

⁶⁹ Bhagwati 2002, p. 26.

developing countries to demand equal treatment as well. Sound economy-wide analysis of trade barriers and preferences would show that, in the majority of cases, developing countries would gain the most from unilaterally removing their barriers to trade rather than seeking preferential access to rich country's markets.

Some of the problems arising from preferential access for developing countries, such as concerns that they undermine the GATT's fundamental MFN principle, also arise with respect to free (preferential) trade agreements. This issue is addressed in chapter 7.

7 FREE (PREFERENTIAL) TRADE AGREEMENTS

The MFN principle is one of the core foundations of the WTO system. The principle underpins open, non-discriminatory trade. If fully implemented, free trade would lead to a competitive system of world exchange for goods and services, and the most efficient use of the world's resources. Bilateral or regional free trade agreements (FTAs) weaken the MFN principle and undermine global, open, non-discriminatory trade. The recent stampede to form FTAs has lead some trade experts to now place FTAs among the most serious threats to the multilateral trading system.⁷⁰ To understand this problem and therefore conceive solutions, it is necessary to first describe exactly what these FTAs imply.

FTAs all involve the selective removal of barriers to trade between a pair or group of countries. The agreements can take several forms. The most liberal arrangement is a complete economic union whereby goods, services, investment, people and money flow uninhibited between parties to the agreement. This arrangement implies the adoption of a common currency. At the other extreme is a limited bilateral or regional FTAs that just removes the trade restrictions between parties. Each party maintains their own external trade policy. Between these two cases lie varying degrees of integration: a customs union is a free trade area

⁷⁰ Bhagwati has written extensively on this subject. A recent description is in Bhagwati, J. 2002, *Free Trade Today*, Princeton University Press, New Jersey.

with a common external tariff regime, while a common market extends a customs union by including the free movement of people and capital. But all of these ‘free trade’ arrangements have something in common: they are *not* free trade. They still discriminate against trade with countries outside the group.

As such, FTAs are strictly preferential trade agreements. Whether under bilateral or regional agreements, parties obtain trade access on terms that are more favourable than for countries that are outside the agreement. That preferential wedge distorts the global pattern of trade from what would occur under Article I: MFN trading arrangements. So FTAs, called more correctly preferential trade agreements (PTAs) by Bhagwati,⁷¹ create trade between the privileged signatories to a trade agreement at the expense of outsiders. That is, trade can actually be diverted away from the least cost source of imports. But this has a welfare cost attached to it. Conceivably, welfare could actually fall as a result of the formation of a PTA. This happens when the trade diversion outweighs the trade creation.

PTAs have other problems as well. When Mexico and the United States established their PTA under North American Free Trade Agreement (NAFTA), Mexican goods and services could then be exchanged preferentially for American goods and services. But what is meant by ‘Mexican’ or ‘American’? To prevent outsiders such as Korea from indirectly exporting goods through either country to one of the NAFTA partners, what is Mexican or American must be defined. Hence, ‘rules of origin’ have to be established. But, depending on how liberal they are, these rules of origin introduce a layer of regulation that can be costly to monitor and enforce. Transaction costs can be higher as a result and neither party to the PTA benefits from that.

⁷¹ Bhagwati 2002, pp. 106–7.

On top of extra transaction costs and trade diversion, PTAs also create perverse incentives. For one thing, just as in preferences given to developing countries, once a preference is granted an incentive is created to preserve that preference. This further blocks global reform. For example, under NAFTA, Mexico receives preferential access for sugar into the American market. Mexico's sugar production and exports to the United States have risen. But global sugar reform would remove this preference. Mexico now has an incentive to block global sugar reform — or at least not to argue for it.

Another perverse incentive created by forming a PTA is the incentive for the preference receiver to push the extra competitive pressure onto third countries.⁷² The country does this by raising applied rates to bound rates, or by the use of non-tariff barriers such as the selective use of safeguards including anti-dumping actions (discussed in the next chapter). This 'endogeneity' of external barriers rising from the formation of a PTA is a real risk.⁷³

But, additional benefits accrue from the formation of PTAs too. Some have argued they can serve as an experimental laboratory for cooperation on issues that have not yet been addressed multilaterally.⁷⁴ Deep economic integration is one such issue that has only been tried bilaterally or regionally.

⁷² Bhagwati 2002, p. 110.

⁷³ Bhagwati 2002, footnote 22, p. 153.

⁷⁴ Hoekman and Kostecki 1995, p. 231 and pp. 247–50. Also, there is a burgeoning literature on whether PTAs are a building block or a stumbling block towards free trade. See, for example, Grisworld, D.T. 2003, 'Free-trade agreements: stepping stones to a more open world', *Cato Institute Trade Briefing Paper*, no. 18, and also Limão, N. 2003, Preferential trade agreements as stumbling blocks for multilateral trade liberalisation: evidence for the US, University of Maryland, unpublished.

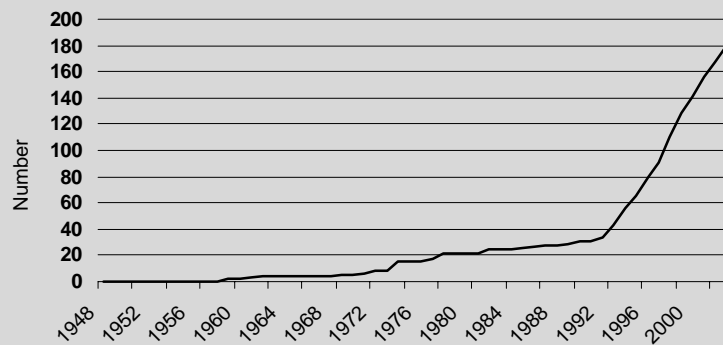
Another advantage of PTAs is that they can set up a political dynamic for reform of inefficient, protected industries that can then be liberalised on an MFN basis. A good example of this is Australia's dairy industry during the period leading up to the formation of Closer Economic Relations (CER) with New Zealand in 1989. At the time, Australia's dairy industry was inefficient and highly protected. New Zealand's industry was (and still is) highly efficient and export orientated. CER with New Zealand allowed dairy products to enter Australia after a phase-in period. Considerable adjustment occurred in the Australian industry, but its efficiency rose and is now equal to that of New Zealand. Today, the Australian dairy industry is one of only two main dairy industries in the world that is totally deregulated on an MFN basis. The impetus for this reform was the bilateral PTA between Australia and New Zealand.

But examples are rare of success stories such as this, where a PTA eventually leads to MFN reductions in protection. And it is not obvious that extending some aspects of deep integration, like competition policy, to developing countries is to their benefit — something discussed in chapter 9. That, and the fact that some PTAs often exclude sensitive sectors such as agriculture, means PTAs have the potential to be damaging to an open world trading system.

The issue of PTAs is all the more pressing because of the recent explosion of such arrangements. Through the fifties and sixties there were hardly any PTAs in force. Numbers rose through the seventies and eighties, but took off after 1990. By October 2003, 154 PTAs were in force out of 262 PTAs notified to the GATT/WTO (see chart 5).⁷⁵ This explosion of PTAs and its implication for the WTO system has trade experts worried.

⁷⁵ WTO 2003, *World Trade Report 2003*, Geneva, available at http://www.wto.org/english/news_e/pres03_e/pr348_e.htm, Accessed 10 December.

5 Regional trade agreements in force by date of entry into force



Source: World Trade Organization 2003, 'Regional Trade Agreements, facts and figures, how many regional trade agreements', http://www.wto.org/english/tratop_e/region_e/region_e.htm. Accessed 8 December.

Many reasons have been advanced for this swing to bilateralism. One is the fear of being left out, which is simply the narrow pursuit of individual interests in an uncoordinated fashion. In a game theoretic sense, no one country can prevent other countries from forming PTAs given the exception under GATT Article XXIV. And to stay out of forming a PTA runs the risk of being discriminated against. If all other countries are busily forming PTAs then for a country staying out of such arrangements it is formally equivalent to a selective tax being imposed on their exports. Countries have no choice but to look after their own interests and join the game.

Another reason for the swing to bilateralism is that countries wishing to undertake multilateral trade reform do not want to be tied to the 'slowest ship in the convoy'. Although MFN free trade is vastly superior, the slowness of global talks to that end and the desire of trade ministers to show some 'gains' are fuelling the current trend to bilateral and regional arrangements. As the slowness of the

multilateral trade negotiation (MTN) process is due to the termites highlighted in this study, repairing these foundations of the WTO system would be a major advance.

However, part of the present slowness of multilateral trade negotiations stems from the large agenda of the Doha round of trade talks. Extending talks into new areas such as competition policy is not obviously beneficial to developing countries, and these countries do not have the resources to evaluate or negotiate these issues. The Doha negotiations could be accelerated by focusing just on market access. Focusing on market access and achieving success on this issue is desirable for reasons outlined in chapter 10. For now, the advantage of successfully focusing on market access is that bilateral or regional PTAs would be rendered irrelevant. If the world achieved MFN free trade, no extra advantage could be gained through forming PTAs.

Given the existence of GATT Article XXIV granting an exception to the MFN clause and permitting PTAs to form, a powerful dynamic to form these bilateral and regional PTAs has been created. Countries have to join in if they are to look after their interests. Staying out of PTAs does not stop other countries from forming them. The solution is multilateral. Either Article XXIV must be rescinded or all countries get on and liberalise all trade on an MFN basis, rendering the PTAs redundant.

The rush to form PTAs is really a symptom of the demise of the multilateral trading system rather than a cause of it. Recognising this points to where the solution lies and the theme of this book: repair the multilateral WTO trading system. First, two other areas for repair need to be discussed.

8 SAFEGUARDS AND ANTI-DUMPING

Under both the GATT and GATS there are a series of provisions allowing WTO members to waive the rules under certain circumstances. These provisions are broadly termed 'safeguards', but are also referred to as 'escape clauses'.

These safeguards exempt members from the rules governing trade liberalisation and bound tariff rates. The various objectives of the safeguards stem from their diverse historical roots. But nearly all safeguards have one thing in common — they are not good economic policy. Some of the safeguards are downright wrong and one of them, anti-dumping, is blatant protectionism dressed up in a different guise. As Finger and Andrei observe, 'anti-dumping is ordinary protection with a good public relations program'.⁷⁶

There are several safeguard provisions under the GATT. The provisions allow either temporary or permanent suspension of countries' general obligations under the agreement. These articles are set out in box 6. As well, there are other safeguards included in WTO accession agreements.

⁷⁶ Finger, J.M. and Andrei, Z. 2003, 'WTO rules that allow new trade restrictions: the public interest is a bastard child', paper prepared for the *UN Millennium Project Task Force on Trade*, coordinated by Ernesto Zedillo and Patrick Messerlin, p. 3.

6 Temporary and permanent safeguard provisions in the GATT

Temporary exceptions include:

- anti-dumping — the pricing of exports below what is charged on the domestic market of the exporting country, resulting in material injury to the domestic industry in an importing country (Article VI);
- countervailing duties — measures, such as tariffs, put in place to offset the effect of subsidies in an exporting country that materially injure the domestic industry of an importing country (Article VI);
- balance of payments — restrictions on imports to safeguard a country's external financial position (Articles XII and XVIII:b);
- infant industries — the allowance of import restrictions to protect infant industries (Articles XVIII:a and XVIII:c);
- emergency protection — temporary protection in cases where imports of a product cause or threaten material injury to domestic producers of directly competitive products (Article XIX);
- special safeguards — provisions embodied in the Agreements on Agriculture and Textiles and Clothing allowing for actions to be taken to restrict trade in these areas; and
- general waivers — allowing members to ask for permission not to be bound by an obligation (Article XXV:5).

Permanent exceptions include:

- general exceptions — measures to safeguard public morals, health, laws and natural resources, subject to the requirement that such measures are non-discriminatory and are not a disguised restriction on trade (Article XX);
- national security — allowing intervention on national security grounds (Article XXI);
- tariff renegotiation — allowing for the withdrawal of certain tariff concessions (for example, tariff reductions that were bound) if compensation is offered to affected members (Article XXVIII).

Source: Hoekman, B. and Kostecki, M. 2001, *The Political Economy of the World Trading System*, 2nd edition, Oxford University Press, New York, pp. 161–2.

With the exception perhaps of bans on trade in goods for health or safety reasons, most of these safeguard provisions do not make economic sense. So why are all these safeguards riddled through the GATT articles? It is clear that trade policy is only indirectly related to the objectives behind each of the provisions, and so decisions will never be made using best economic policy. For example, it is better to support infant industries (if at all) through explicit, transparent, accountable programs from government rather than hidden transfers to producers from consumers via a tariff.

Another example concerns the balance of payments safeguards. The safeguard allows a country to restrict imports to protect its balance of payments. But, in a world of capital flows where goods are used both as capital inputs and for final consumption (such as cars), restricting imports to improve the current account of the balance of payments has the unwanted effect of ‘crunching’ the domestic economy. The reason is that the balance of payments is inextricably linked to the balance (or imbalance) between domestic savings and investment. Using trade restrictions to fix balance of payments problems is not first best economic policy. The underlying reasons for balance of payments problems have to be addressed — these invariably turn out to be domestic and can be exacerbated by restrictions on trade. In recognition of this, the IMF and World Bank routinely obtain agreements from borrowing governments *not* to introduce import restrictions for balance of payments purposes.⁷⁷ Unsuccessful attempts were made to close this balance of payments loophole in the Uruguay Round negotiations.

The question of why the GATT contains all these economically flawed safeguards boils down to politics.

⁷⁷ Hoekman and Kostecki 2001, p. 188.

Governments wishing to liberalise will always be subject to extreme pressure from sectors sensitive to liberalisation. Rather than jeopardise a whole liberalisation program, 'let out' clauses are negotiated to provide political comfort. The intention, of course, is that 'special circumstances' will not easily apply and domestic groups insisting on protection will find it harder to obtain. In that way, liberalisation programs can proceed. Therefore, these safeguards have different justifications, which can amount to 'unfairness', 'exceptional circumstances', 'infant industry support' and so on.

But despite these different justifications, all of the safeguards have the same intent — protection — and the economics behind them can be very similar. For example, the economics of countervailing duties is the same as anti-dumping except countervailing duties provide an incentive for the exporting country to avoid using subsidies. Even though these safeguards share characteristics, by far and away the safeguard most frequently used is anti-dumping. Since the Uruguay Round there have been around 2000 cases. Hence, to see why safeguards are bad policy and why they are corroding the WTO system, the focus of the rest of this chapter is on anti-dumping.

Anti-dumping

'Dumping' is where a foreign firm sells goods to an importing country cheaper than it sells the same goods on its local market. The GATT rules allow an anti-dumping duty (tax) to be imposed on the imported good if this dumping causes material injury to local producers. The affected local industry is thereby legally protected.

There are two problems here — one administrative, the other economic. The administrative problem is that a 'normal value' has to be established for the goods when

sold in the country of origin. The dumping test, then, asks simply 'is the imported good being sold at less than its normal value?'

Determinations under this test are difficult even in open market economies due to normal commercial practices such as price differentiation. But for an economy in transition with a lot of trading by state owned enterprises, like China, determinations can be nearly impossible. Accordingly, there is far more 'latitude' in these countries so the concept of whether a foreign government can 'control' the price is often used in assessing 'normal value'. Some western countries concerned with dumping have proposed using the more nebulous concept of whether a foreign government can 'influence' the domestic price as part of the assessment of normal value in the dumping test. With 'price influence' as the measure it is easier to find dumping.

Seemingly, there is nothing wrong with dumping tests, for surely dumping must be bad for the importing country. However, *mostly it is not*. That highlights the more serious second problem — anti-dumping legislation is lousy economic policy.

'Dumping' of foreign goods in an importing country has two effects. One is the *cost* to a local manufacturer who must now compete with the cheaper imports. It may 'injure' the local producer's sales and cause it to lay off workers. This has negative ripple effects through the economy.

The second effect from dumping is the *benefit* to consumers. Consumers, either households or other firms, now have access to cheaper goods. These savings allow them to spend their money elsewhere. This has ripple effects too, only this time they are positive, such as generating jobs elsewhere.

When all direct and secondary ripple effects are properly measured, if the benefits exceed the costs, allowing dumping of foreign goods is in the national interest. You would be forgiven for thinking that this is what governments assess. Not so. The anti-dumping legislation of practically every government in the world considers *only* the costs. Governments do not consider the benefits to consumers or the economy. Dumping reviews are legally biased to find in favour of just one stakeholder — the local manufacturer. It is no surprise that anti-dumping is the new protectionism.

This combination of the economically biased assessment and the administrative fluidity in determining 'normal value', especially for economies in transition such as China, make anti-dumping the protective weapon of choice. There are several examples where a country wanting to protect an industry uses examples of transactions showing dumping has occurred, but discards those transactions with higher export prices showing the opposite of dumping, the difference being due to the normal fluctuation of export prices.⁷⁸

Other problems exist too. Anti-dumping is wound up in arcane legal text and procedures that few understand apart from specialist lawyers. Further, there is a complete lack of transparency because often the results of determinations are not made public. For example, in some countries such as Australia, the Customs Department will not even announce the amount of dumping duty imposed on a particular good unless one is a bona fide importer.

None of the above is new — the problems surrounding anti-dumping have been known for years. The intriguing thing about anti-dumping laws is that they have persisted for so long despite obviously being counter to the national interest. The 'unfair' competition label is so strong that the

⁷⁸ Finger and Andrei 2003, p. 15.

public relations campaign legitimising import duties against foreign products outweighs the national interest.

Some of the political support for 'unfairness' comes of course from the 'exports good, imports bad' fallacy treated in earlier chapters. In passing, this shows how one weak foundation of the WTO system compounds errors and mistakes in other parts of the system. The result is an inconsistent, incoherent message to the public and policy-makers on the benefits of free trade. And if there are no consistent or coherent principles to apply in cases where the rules are breached, the only resort is the application of raw political power — or in the case of anti-dumping, legal muscle. Interests of the big and powerful are favoured over the interests of smaller countries — the very situation an open, non-discriminatory, rules-based multilateral trading system is supposed to prevent.

But there is an easy solution to remedy wrong anti-dumping policy — assess both the benefits *and* the costs of dumping claims. Predatory pricing to drive out a local producer will show up in the cost-benefit test. Also, the administrative difficulty of determining 'normal value' in dumping claims will be neutralised. If an artificially low 'normal value' is struck in order to show dumping, the costs to local producers will be greater. But the benefits to consumers will be greater as well. The incentive to inflate the calculation of dumping margins is removed once consumer benefits are included in the assessment of injury.

Another advantage of cost-benefit tests is that economics is reintroduced into trade policy and the legalism that has crept into the WTO system is de-emphasised. The problem with an overly legalistic approach to trade policy was noted earlier in chapter 5.

The other safeguards in the GATT would also benefit from exactly the same treatment as proposed here for anti-

dumping. Optimally, there needs to be only one safeguard provision in the GATT instead of the plethora of articles now. That provision would allow protection of a domestic industry *only* if the country concerned first conducted an open, transparent and independent economy-wide analysis of the benefits and costs from intervening in trade.

9 NEW AREAS

Such is the confusion and muddled thinking about trade policy that even the recent debate about extending the WTO system to cover the ‘new areas’ of world trade stands to further erode the WTO’s foundations. These new areas follow from the extension of the GATT system during the Uruguay Round negotiations to include services, sanitary and industrial standards and intellectual property rights (the TRIPs agreement). Since then, the agenda has expanded further with attempts to formally include labour and environmental standards as well the four ‘Singapore issues’ of investment, competition policy, transparency in government procurement and trade facilitation.

Each of these new areas has different economics (and politics) behind it. Potentially, certain areas could be manipulated by protectionist interests and restrict trade — the opposite of what the WTO system stands for. As such, some of these new areas are loaded with potential to become future ‘termites’ that could further erode the WTO system. They also have the potential to confuse thinking about trade and the basis for the WTO system further, with genuine trade liberalisation either stalling or slowing as a result. But if a clear and coherent set of principles supported the WTO’s institutional arrangements, far less angst over some of these new area issues would arise today. Some issues would not even be on the agenda.

Consistent with the theme of this study, the purpose of this chapter is to highlight the inconsistencies and dangers in

some of the new areas of the WTO system. This chapter does not give a detailed treatment of each new area issue because each one is a major subject in its own right. Rather, this chapter focuses on the potential for future erosion of the WTO's foundations and solutions to prevent this.

Backdoor intrusionism

First, the impetus behind the inclusion of new areas in the WTO system is multifaceted. Part of the motivation is the drive for deeper integration of the global economy. Globalisation is driven by the recognition that removing transaction costs can facilitate exchange and trade, thereby lifting incomes. Some of this harmonisation makes sense if it reduces transaction costs in a cost-effective way. But 'harmonisation' has been interpreted as 'sameness' — that all countries should have the same standards, procedures and rules. Yet the whole basis for trade depends on the *differences* between countries — whether they are from preferences, culture, resource endowments, climate or any other thing. Combining these differences to produce different goods and services is what causes the benefits of trade.

The problem is that forced harmonisation under the WTO system — particularly in these new areas — can reduce a country's ability to exploit its differences, and therefore any trade advantages that follow from it. There are many current contentious examples: some countries pay high wages, while others cannot afford to do so; some have an abundance of resources, others do not; and only some countries have the intellectual, human and legal resources to implement institutional agreements such as TRIPs. Yet, when TRIPs was negotiated in the Uruguay Round it was implicitly assumed that harmonisation was a good thing and that developing countries had the financial and intellectual resources necessary to implement the TRIPs agreement.

TRIPs represents harmonisation with detailed prescriptions on how international standards for intellectual property rights should be enforced domestically.⁷⁹ Bhagwati aptly calls this backdoor ‘intrusionism’⁸⁰ and it leads to two problems: one political, the other economic.

The political problem is that a country’s sense of sovereignty is directly impinged when outsiders dictate how that country should run its internal affairs. That sense of ‘attack’ on sovereignty only leads to resentment and a political backlash against globalisation, and that has bad effects. When the anti-globalisation forces won ascendancy in Seattle in 1999 by stymieing the ministerial trade meeting, they also caused the failure to launch a new round of trade talks. Certainly, the removal of border trade barriers also impacts on the domestic affairs of a country, but that effect is indirect and is not the same affront on national sovereignty in the minds of many people.

The economic problem with dictating to others how they should organise their internal institutional arrangements is the ‘one size fits all’ premise behind the arrangements. Many developing countries do not have the resources to implement arrangements such as TRIPs. So, for the bulk of the WTO’s members, the benefits of complying with that agreement do not outweigh the costs. For example, Finger found that as of 1 January 2000, 80 or 90 of the (then) 109 developing and transition economy members were in violation of the sanitary and phytosanitary, customs valuation, and TRIPs agreements.⁸¹ He also found that implementing their WTO obligations under these three agreements would cost each country around US\$150 million — for many a

⁷⁹ Razeen 2003, p. 5.

⁸⁰ Bhagwati 2002, *Free Trade Today*, p. 67.

⁸¹ Finger, J.M. 2000, ‘The WTO’s special burden on less developed countries’, *Cato Journal*, vol. 19, no. 3. http://www.cato.org/pubs/journal/cj19n3/cj19n3_9.pdf, Accessed 20 October, p. 435.

full year's development budget! This, Finger asserts, would be a bad investment compared to expenditure on other areas such as education.

For new members of the WTO such as Cambodia, a well-working legal system and a system of property rights integrated into a financial system is far more important than implementing the TRIPs agreement, a new customs valuation system or introducing competition policy rules. As Finger and Nogués ask, 'What is the sense of changing customs valuation systems when it takes 60 days to move a container?'⁸² Perhaps the extraordinary thing is that there was so little analysis of the benefits and costs of TRIPs for developing countries prior to and during the Uruguay Round. So it comes as little surprise that developing countries are suspicious of expanding the agenda of the Doha round of trade talks to include the proposed new areas.

Labour and environmental standards

Two new areas with great potential to act as protectionist devices are labour and environmental standards. Including either of these two issues in the WTO system would play directly into the hands of protectionist interests. Neither issue would enhance contestability of markets — in fact, the opposite would occur.

The motives for including labour and environmental standards in the WTO system have common roots. Both issues are concerns expressed by people and interest groups in rich countries, and both raise fears of a 'competitive race to the bottom' in each area as a result of an open trading

⁸² Finger and Nogués 2002, p. 338.

system.⁸³ The argument for common labour standards (in wages as well as such things as working hours, worker safety and child labour) is that open trade will simply relocate jobs to the country paying the cheapest wages, with the weakest labour standards. Similarly, factories and production around the world will move to those areas where environmental regulations are the weakest (or non-existent). Some even argue that trade is the cause of much of the current environmental degradation on the planet.

While much of this argument about the 'race to the bottom' has simplistic appeal, it is wrong. It is wrong on theoretical grounds as well as on the facts, discredited as it is by the evidence. This simple argument makes the mistake of ignoring the effect that rising incomes have on demands by local residents for better working and environmental conditions. As people become richer they also become better educated and better informed. Their preferences correspondingly change from basic food, shelter and clothing to more advanced services including better workplace safety, improved health, more leisure time and a cleaner, safer environment. As established earlier, trade is one of the basic mechanisms that lifts incomes. The prosperity caused by increased trade then leads to demands for better labour and environmental standards. Moreover, as the mechanism is driven by internal demands, it is more enduring than a regime imposed from outside.

On top of the theoretical inadequacies of the 'race to the bottom' argument, there is also a lack of evidence of the phenomenon that, according to Drezner, 'is startling'.⁸⁴

⁸³ Curzon Price, V. 1999, 'Right and wrong ways of addressing labour standards and environmental concerns', in Stoeckel, A. and Corbet, H. (eds), *Reason versus Emotion: Requirements for a Successful WTO Round, Seattle 1999*, RIRDC Publication No. 99/167, Canberra, p. 52.

⁸⁴ Drezner, D.W. 2001, 'Bottom feeders', *Foreign Policy Magazine*, vol. 122 January/February, Washington DC.

Rather, evidence shows that as countries globalise and get richer, labour and environmental standards improve. If there was a race to the bottom, then such an erosion of standards should be observed, for example, as between the domestic free trade zones introduced within certain countries. Instead, the opposite has happened.

Besides the above issue on whether trade has a positive or negative effect on the environment or labour standards, there is the issue of the size of the effect. Trade is only a fraction of a country's total economic activity. So, to tackle abuses of labour, human rights or the environment, it is far better to use policies that address those concerns directly. That is particularly the case when the problem (called 'distortion' or 'market failure' by economists) is domestic.

The few cases where the source of market failure is external (for example, atmospheric pollution crosses a border) raises the possibility of a departure from free trade being optimal. Economists tied themselves in knots for years over these special cases.⁸⁵ But, as Bhagwati documents, either the small gains from departing from free trade do not justify the intervention or the possibility of intervention leading to retaliation means the case for free trade still stands.⁸⁶

Restricting trade is not the route to efficiently achieving desired social outcomes. When the real world experience of trade policy capture by protectionist vested interests is added, the use of trade policy to correct social problems can be downright dangerous. But should, what Krugman⁸⁷ calls, 'a little bit of pragmatism' be allowed for both political expediency and some harmonisation of WTO

⁸⁵ For a readable description of the evolution of this debate and optimal policy response when the distortion is external, see Bhagwati, J. 2002, *Free Trade Today*, Princeton University Press, New Jersey.

⁸⁶ Bhagwati, J. 2002, pp. 29–33.

⁸⁷ Krugman 1997, p. 120.

standards? No, if past experience is any guide. That experience shows that, once open, any loophole for protectionist pressure becomes abused, including sound principles of open, non-discriminatory trade. For example, GATT Article XIV, which allows formation of PTAs, was originally an innocuous inclusion to allow for the free trade agreements already in existence. It has now become a loophole in the stampede to form PTAs and, as shown in chapter 7, weakens the multilateral WTO trading system.

Competition policy

Including competition policy — one of the Singapore issues — in the WTO system raises slightly different issues to those raised by labour and environmental standards. Competition policy falls in the same class as TRIPs in that it is not necessarily in the interests of developing countries because it involves introducing complicated and expensive institutional arrangements. Like TRIPs, competition policy is not necessarily win-win, which is, however, the case with the removal of trade barriers. Developing countries are right to be wary of the inclusion of competition policy. Like TRIPs, competition policy was not scrutinised under cost-benefit analysis for developing countries before being placed on the negotiating table.

The call for competition policy as part of WTO trade talks highlights an inconsistency in trade policy by some. The main proponents for the inclusion of competition policy in the Doha trade talks were Japan, Korea and the European Union (which withdrew its demand at the last minute before the Cancun ministerial meeting failed). But competition policy, if it is to mean anything, implies a more competitive (and hence productive) domestic economy. The best way of introducing competition in the domestic market is to open trade at the border. But the European

Union, Japan and Korea are among the most obstinate in the world at removing trade barriers in agriculture! Again, such inconsistent and illogical treatment of trade policy continues to confuse and cloud thinking about trade. Without the application of a correct and coherent set of principles and the analysis of policy against those criteria, the WTO system is threatened. If decisions are not made on the basis of logic and reason, they will be made on the basis of political power. The outcomes are therefore uncertain and this lack of predictability erodes confidence in liberalising trade. The world is poorer as a result.

The best defence against wrong-headed thinking and potentially damaging aspects of some of the WTO's proposed new areas is good, clear analysis of the benefits and costs of those policies in an open and transparent way. That introduces the final topic: what to do now.

10 WHAT TO DO?

The world trading system is under threat. The Doha round of trade talks has come to a halt and there is no way they can now be completed by their scheduled deadline at the end of 2004. Much has been written about the failure of the Cancun ministerial trade meeting in September 2003. Blame is variously attributed to the stances taken by developing countries, the European Union and the United States at the Cancun meeting and the lack of change in negotiating positions. But this study argues that this failure has been long in the making because it is symptomatic of a more underlying, deep-seated problem with the WTO system.

However, there is a lack of widespread recognition that the multilateral trading system regulated under the auspices of the WTO is under threat. Fundamentally, too few countries are committed to open, rules-based, multilateral free trade. Rather, too many work the WTO's system of rules for their own ends.

This lack of commitment reflects confusion and muddled-thinking by officials, trade ministers and the public about the benefits of free trade. And where there is confusion, special interests find fertile territory to peddle their protectionist wares.

Why all the confusion and muddled-thinking about trade policy? It comes from illogical and inconsistent positions on different aspects of trade policy advanced by the major

players and, in some cases, outright bad policy. Confusion also stems from inconsistent rules in the WTO itself. As seen in earlier chapters, one rule says open, non-discriminatory trade is the guiding principle of the multi-lateral trading system, but another rule *allows* discrimination. On top of that, the various articles of the GATT are riddled with special and differential treatment provisions for developing countries, which violate the GATT's fundamental principle of MFN. As for anti-dumping, one rule effectively says that dumping is bad, yet part of another WTO agreement dealing with agriculture *permits* dumping. And the process of assessing anti-dumping claims is flawed — it is a biased, one-sided affair leading only to protectionism.

If that were not enough, we are still in the position where sectors of vital importance to the bulk of the membership of the WTO — developing countries — are excluded from meaningful liberalisation. Then there is the illogical position of some of the major players in steadfastly refusing to introduce competition into their agricultural sector, while concurrently arguing strongly for competition policy to be on the agenda of the Doha round of trade talks. Finally, the process of negotiating reductions in trade barriers is based on flawed economics and sends out the wrong 'exports good, imports bad' message. All of these factors — the lack of coherence and consistency in the principles of trade policy, the confusion resulting from that, and the lop-sided confinement of residual protection to just one sector, agriculture — are making liberalisation nearly impossible to secure.

It is intriguing to question why all of this has gone on for so long. After all, nothing in the preceding chapters is particularly new to good trade economists. What *is* new is the bringing together of these inconsistencies in the WTO rules and flaws in trade policy to show how the collective

action of each 'termite' is eroding the foundations of the WTO. Also, highlighting the flaws together in one study shows how one bad bit of policy feeds on another, which can suggest solutions. For example, it is only natural the wrong 'exports good, imports bad' message results in anti-dumping policy that treats cheaper imports as bad, even though in reality, anti-dumping actions harm the export sector.

Another reason the flaws in the system have persisted for so long is that many good trade economists have gone along with reciprocity in negotiations to lower barriers despite its flawed economics. They have done this because reciprocity once made good political sense and, in the minds of many, worked. But things have changed on two counts. First, in the developed world where most trade occurs, whole sectors such as manufacturing are now largely free of trade barriers. The same natural constituencies that lobbied for change in the Tokyo and Uruguay Rounds no longer exist. As the agenda moves away from, say, refrigerators or cars to competition policy or environmental standards, the direct link to a producer's bottom line disappears. Politically, the constituency that would push hard for free trade is smaller than before.

The second change is that, by embracing the politics of mercantilism to get a good outcome, people have become convinced over time that mercantilism is right even though the concept is economically flawed. Exports are promoted, never imports. The *only* purpose of exports is to pay for welfare enhancing imports, but this simple point has been lost. A generation has been miseducated about the benefits of trade liberalisation.

Key: economy-wide analysis

In determining why it has taken so long to fix these issues, yet another fertile line of thought is to consider the reasons behind the prevalence of bad policy in many other areas, such as rent controls or commodity price stabilisation schemes. The fundamental reason for bad policy, which cannot be emphasised strongly enough, is that the secondary consequences of policy actions are overlooked. Only the first round immediate effects are considered — mostly costs impacting on the special interest group pleading for the policy. Hazlitt, in his book *Economics in One Lesson*, claims ‘nine-tenths of the economic fallacies that are working such dreadful harm in the world today are the result of ignoring this lesson [of looking at secondary consequences]’.⁸⁸ Bad trade policy falls into this category. Although that claim was made years ago, the same conclusion would stand today. Looking at ‘secondary consequences’ is just another way of saying ‘economy-wide analysis’. But the failure to measure the benefits as well as the costs is, in some cases, even worse than mere oversight — it is deliberate. In anti-dumping cases, for example, the law in practically every country in the world precludes the ‘unseen’ secondary effects (the benefits for consumers) from being measured.

Economy-wide analysis entails consideration of all linkages and secondary effects in a sector protected through a policy. It involves looking at both the benefits and costs of the policy. There are several ways this can be done. One early technique was to measure the *effective rate* of protection. In this method the penalties on an industry as a result of protection *elsewhere* in the economy are considered along with the benefits the protected industry receives. Today, with advances in computing techniques, economy-wide

⁸⁸ Hazlitt, H. 1979, *Economics In One Lesson*, Three Rivers Press, New York.

analysis involves computable general equilibrium (CGE) models and is routinely undertaken by academics and other researchers. This type of analysis is particularly useful to measure the effects of the numerous policy changes proposed in the Doha Round negotiations.

All of the linkages in an economy are automatically taken into account in an economy-wide analysis of trade policy. Take, for example, protection of the sugar industry in the United States. Economy-wide analysis will not only measure the benefits of protection to the sugar producers, but also the extra costs to consumers and other industries that use sugar, such as the chocolate makers in Chicago. Because exporters necessarily bear the burden of import barriers, the effect on exporters such as the Boeing Corporation in Seattle, is also measured. With agricultural trade liberalisation and removal of protection for US sugar farmers, Brazil would be able to export more sugar to the United States. But the *only* thing Brazil can eventually do with their extra earnings of foreign exchange is purchase imports, one of which in all likelihood is new aircraft, potentially from the Boeing Corporation in Seattle. This extra sale by a US exporter is captured in economy-wide analysis. And economy-wide analysis can be extended to other secondary or downstream effects, such as the environment. To continue the example of sugar protection, the United States sugar industry is having a major adverse impact on the Everglades in Florida and that concerns the greens.⁸⁹ This small example shows just how many groups bear the burden of protecting one industry — consumers, exporters, and environmentalists to name a few. These groups are best identified through economy-wide analysis. If enough groups bearing the burden of protection become convinced of the need for change, reform is more likely.

⁸⁹ Humphreys, van Bueren and Stoeckel 2003.

The operative word of the last paragraph is ‘convinced’. Economy-wide analysis on its own is not sufficient to educate the public and policymakers of the harm caused by restrictive trade policies. Proper *process* is required. It is necessary to conduct economy-wide analysis openly by an independent agency so each stakeholder can see and comment on the other stakeholders’ submissions. So, for example, sugar farmers would be able to comment on the greens’ input to ensure that exaggerated claims are not made and vice-versa. A draft report by the independent agency should then be produced, and made available for written comment by all concerned.⁹⁰ Through this *process*, those who benefit and those who bear the burden of the policy are identified. There will be a natural coalescing of those losing from the policy — in this case, the chocolate makers, the aircraft manufacturers and the greens, let alone consumers — to lobby the government for change. That is, *an open, independent process of economy-wide analysis changes the politics of protection*.

Protection is, after all, a political game. The current negotiations are no exception, because the ‘exports good, imports bad’ mentality of these negotiations is known by any good economist to be economic nonsense. But this nonsense makes the politics of removing remaining protection even harder. By contrast, economy-wide analysis makes economic sense *and*, when conducted through an open, transparent and independent process, makes political sense as well. When conducted in this manner, the politics for reform is also ultimately more powerful. With more correct

⁹⁰ Specifically, the process of review has to involve a terms of reference issued to the independent reviewing agency, which then puts out an issues paper setting out the review framework and identifying key stakeholders. The agency calls for submissions and holds public hearings (anyone can see and comment on any other submission), and produces a draft report. Comments on the draft report, also in the public domain, are considered and incorporated as required, and a final report produced, which must be considered by government.

analysis undertaken, policymakers and the public will become more educated about the economics of trade protection. This changes the mindset of those reviewing claims for assistance and becomes built into government internal processes. The politics of protection changes with this education, making it harder for narrow vested interests to dominate the national interest.

The proposition that open, independently conducted economy-wide analysis of protection changes the politics of protection is not just theoretical. The best example of this process working in practice is Australia. During the 1970s an independent agency, then called the Industries Assistance Commission, was established. Its task was to systematically review Australia's import protection and provide assistance to industry. Reviews were conducted through an open and transparent process of economy-wide analysis, uncovering and tracing all hidden and unseen secondary effects of the policies. Initially, the politics of protection proved hard to shift. The carmakers and textile manufacturers fought hard to retain their high levels of tariff protection. With time, however, the politics changed. It became apparent that Australia's miners and farmers, the two main export groups, were bearing the burden of protection. They joined forces to form a coalition for reform that the government could not politically resist. Australia then embarked on a path of unilateral liberalisation to the benefit of the economy.⁹¹ Although pockets of low protection still remain, Australia is one of the relatively open economies of the world today.

The reduction in protection in Australia was the result of an open, independent process of systematic and repeated

⁹¹ A good account of Australia's experience is by Banks, G. 2003, 'Gaining from trade liberalisation: some reflections on Australia's experience', Presentation to the IBBE&L/CEDA Conference, 'New Horizons in Trade: The WTO Round and Australia's Free Trade Negotiations', Adelaide Convention Centre, 5 June.

economy-wide analysis of protection. Critically, the mindset of enough people in Australia had changed to swing the politics in favour of liberalisation. Narrow, selfish, vested interests still exist; they always will. But, with few notable exceptions, mostly the economic debate reported in Australia's responsible media highlights the secondary benefits of policy choices, portraying a balanced view of the issues.

If systematically considering the secondary or economy-wide effects of trade policies through an open and independent review is this important, it is astounding that such analyses are rare. Yes, there are plenty of academic analyses of the economy-wide effects of trade policies, but studies conducted in conjunction with good governance processes are few and far between. Interestingly, countries, such as Australia, choosing to routinely subject trade policy to this combination of analysis and due process have seen significant unilateral liberalisation of trade to the benefit of the country.

Key: expand the role of the TPRM

This economy-wide analysis of secondary effects should be done as part of the Trade Policy Review Mechanism (TPRM) of the WTO. But, currently, the TPRM only records the facts of trade policy, such as the level and incidence of tariffs and other barriers. Reviews contain no economic analysis of the benefits and costs of the trade policy regime they report on.

Although it helps trade liberalisation, the TPRM, introduced as part of the Uruguay Round, is inadequate. Two changes are required: extension of its mandate to include economy-wide analysis of the benefits and costs of trade policy; and utilisation of an independent agency in each of the capitals of members to conduct the analysis, rather than

the various trade departments around the world. Reviews need to be regularly conducted, as they are now, and include an opportunity for outside critique and comment.

Note that the open, independent and systematic review of trade policy has to occur in the capitals of the world, not Geneva. The role of the TPRM would then be that of an 'auditor', ensuring that both good professional analysis is done consistently and comparably across members, and that correct procedures are followed. This extra transparency should not be an additional burden as rich countries will absorb the bulk of this work — the richest 20 members account for 80 per cent of world trade.

For many other countries, mostly developing countries, the World Bank routinely undertakes economy-wide analysis. The limiting factor in this work is that it is not locally conducted, reducing the capacity for due process. Capacity building efforts in these countries should be directed to enhance each country's ability to analyse policy through open, independent processes and to develop the human capital necessary to make intelligent choices.

The argument that the WTO needs greater transparency is not new. Carmichael and Duncan have elaborated the need for greater domestic awareness about what is at stake in trade liberalisation.⁹² Garnaut makes the same point about the greater need for transparency in the WTO.⁹³ And the report by Long focuses on the link between domestic

⁹² See, for example, Carmichael, W.B. and Duncan, R.C. 2001, *Australia and the World Trade Organisation: Supplementary Submission to the Inquiry into the WTO Conducted by the Joint Standing Committee on Treaties*, 30 January and 25 May.

⁹³ Garnaut, R. 2003, 'Requiem for Uldorama: a plain but useful life', Paper presented at the Committee for Economic Development of Australia (CEDA) Trade Forum, 'New Horizons in Trade: The WTO Round and Australia's Free Trade Negotiations in Post-Iraq 2003', Adelaide, 5 June.

policy transparency and trade liberalisation.⁹⁴ The Long report itself is an extension of ideas promoted in the Leutwiler report,⁹⁵ which is mentioned in the introduction and is partly responsible for establishing the TPRM. The need for agricultural supports to be more transparent lay behind the OECD's thrust to measure 'producer subsidy equivalents'⁹⁶ in the mid-eighties. As noted in chapter 3, these PSE measures are problematic in that they do not capture the economic cost of agricultural support. Now, the economy-wide costs and benefits of agricultural support need to be measured under an open, independent process.⁹⁷

As can be seen, there is recognition of the need for greater transparency of trade policy, and some progress has been made. The next step — full economy-wide cost-benefit analysis through open, independent processes — is simply the next progression. Furthermore, this step would straighten out wrong mercantilist thinking. Open, independent economy-wide analysis would demonstrate to countries they would be better off unilaterally removing their barriers to trade. This is important for developing countries that see their plight as the result of the actions of others instead of their own.

Economy-wide analysis combined with good public governance processes would also have implications for anti-dumping cases. Consumer interests would automatically be included and this balanced view of the issue would educate

⁹⁴ Long, O., et al. 1989, *Public Scrutiny of Protection, Domestic Policy Transparency and Trade Liberalisation, Special Report No. 7*, a report for the Trade Policy Research Centre, London.

⁹⁵ Leutwiler 1987.

⁹⁶ Now called 'producer support estimates' or PSEs.

⁹⁷ An earlier study to measure economy-wide costs in several countries was Stoeckel, Vincent and Cuthbertson (1989), but, again, this was an academic study.

the public about the real advantages and disadvantages of imposing anti-dumping duties. The same analysis and procedures would show countries entering into bilateral or regional preferential trade agreements that the net economic gain, if positive at all, would be paltry compared to the gain obtained by unilaterally removing *all* barriers to *all* markets. Further, this analysis would show that the gains from unilateral reform are slightly smaller than those achieved by multilateral trade reform. These demonstrations would lead to more support from the public — and therefore policymakers — for multilateral liberalisation.

If countries were convinced today of multilateral trade reform and actually implemented those reforms, the distorting effects of preferential access granted to developing countries would be removed along with the perverse incentives they create to block trade liberalisation. Multilateral trade reform would also remove the incentive for countries to form bilateral preferential trade agreements (erroneously called free trade agreements) that are both a symptom and a cause of the weakening of the world trading system.

The long term answer to all of these problems that impede the liberalisation of world trade is therefore to modify the existing TPRM processes conducted by the WTO by instilling a more coherent, consistent set of principles — including economy-wide analysis and due process — behind the WTO system. Existing TPRM processes contain no economy-wide analysis (in fact, they contain no economic analysis of costs and benefits at all), and are neither open nor independent. Stakeholders cannot make submissions, which would be subject to public scrutiny and comment, to the review body, and the reviews submitted to the TPRM are prepared and vetted by departments of trade around the world. These departments typically promote

exports and resist imports. They generally are not bastions of trade liberalisation.

The politics of protection for keeping agricultural trade restrictions and bad anti-dumping laws is so strong that reliance on the Doha negotiations and the one interest group pushing for change, the exporters, will not be sufficient to lead to trade reform. Other groups must be brought into the political equation. The best way to do this is through open, independent economy-wide analysis of all the secondary and intersectoral effects of protection. Through this process the politics of protection changes. Not only does it make sense — it works.

Meanwhile ...

To be effective, the TPRM's exercise with economy-wide analysis and open, independent review has to be done repeatedly, which takes time. But there are nine things that can be done now to encourage the Doha negotiations to make significant gains in trade liberalisation.

Recognise the problem

The first step is to recognise the problem — the WTO system is in trouble, and countries must see benefits in order to *want* to remain members of a club with binding rules. Their desire to remain effective members while agriculture remains so highly protected will wane because it is so important to the bulk of the WTO's membership.

It must be recognised that each compromise of sound principle — no matter how little or pragmatic it may be — feeds on itself and collectively causes confusion, cynicism and mistrust. And countries need to recognise that where confusion exists, special interests find fertile ground to use political power to push their protectionist point-of-view.

Secure market access for agriculture

The second step follows from the above — get movement on agriculture by making market access the priority. The agricultural debate on reducing protection has become distracted by differences in emphasis between the ‘three pillars’ of agricultural policy — domestic support, export subsidies and market access.

There are eight reasons why gaining greater market access is more beneficial to the world trading system than lowering export subsidies or domestic support. The reasons are grounded in good economics as well as politics.

First, policymakers seem unaware that the ‘three pillars’ of agricultural policy are all interrelated. Changing one area has implications for others. Removing barriers at the border and thereby increasing market access automatically eliminates export subsidies — two beneficial reductions are achieved for the price of one.

Second, lowering trade barriers also puts extra pressure and transparency on domestic supports. It makes the real costs of support more obvious to taxpayers. In this way, greater market access sets up a dynamic leading to further reform — three beneficial results could be had for the price of one.

Third, removing barriers at the border (tariffs and quotas) has the advantage of being simple, clean, and easy to measure, as well as being transparent and easy to police and enforce. By comparison, removing domestic supports — whether they are ‘green box’⁹⁸ or not — can be complicated, non-transparent and difficult to enforce. It is easy to substitute one domestic program for another. But this is not the case for border barriers — either they exist

⁹⁸ Green box support measures are those measures that are exempt from commitments to reduce domestic support. The measures agreed under the Uruguay Round were minimally trade distorting, such as spending on research and development.

or they do not. To test for their existence, an exporter can always just load up a container.

Fourth, unlike removing domestic subsidies, lowering trade barriers does not as obviously impinge on national sovereignty. This helps avoid the sovereignty argument used by anti-globalisers that one country should not tell other countries how they should conduct their internal affairs.

Fifth, given that agriculture stands out as the most highly protected sector, lowering trade barriers eliminates the value of preferential trade access granted to developing countries. These preferential access arrangements were shown earlier to be 'poisoning' the world trade talks and creating a perverse incentive for some countries to block liberalisation.

Sixth, free multilateral trade at the border, if achieved for agriculture, could set a precedent for other remaining industries and so eliminate the need for negotiations on regional or bilateral FTAs. Multilateral free trade would make FTAs pointless.

Seventh, lowering barriers at the border introduces competition. This is one of the major planks of any half-decent competition policy, judged to be so important by some of the major players.

Finally, securing greater market access in agriculture and other protected areas also makes political sense — it is the 'bread and butter' of the old GATT/WTO. These eight reasons demonstrate why securing market access is far more productive as a priority for the long term removal of agricultural protection.

Analysis of the adjustment problem

One of the major stumbling blocks to agricultural trade liberalisation is fear of adjustment. Farmers fear that, without support, farm values will fall and their livelihoods will be threatened. It is difficult for them to adjust to these conditions, but easy to organise themselves politically to keep the protection going. Yet research shows these fears are exaggerated. In those rare cases where farming has been liberalised, industries have adapted to the change and prospered due to large gains in efficiency. Reductions in support for the Japanese beef industry is one such example. The tariff on beef imported into Japan fell from 70 per cent in 1991 to an applied rate of 38.5 per cent by 2001. But production of domestic Wagyu beef actually rose slightly since liberalisation started. Cost savings and product differentiation explain this outcome.⁹⁹

Another well-documented case is New Zealand farming. There, all forms of farming subsidies were removed in one fell swoop in the 1980s. An enormous increase in productivity resulted. For example, sheep numbers fell by 29 per cent while lamb production rose 35 per cent.¹⁰⁰ Environmental benefits were felt too, with the marginal hillside land previously devoted to sheep farming being returned to agro-forestry. Since the removal of subsidies, the size of New Zealand's farming sector has increased by 40 per cent. The number of fulltime farm workers has increased. The initial adjustment felt was less than anticipated.

An even more striking example of an increase in the prosperity of farmers upon removal of agricultural protec-

⁹⁹ Honma, M., 2003. 'Japan: product differentiation — the way forward', in Centre for International Economics, *Magellan Project: The Political Economy of Beef Liberalisation, A Collection of International Papers*, Canberra, p. 116.

¹⁰⁰ Humphreys, van Bueren and Stoeckel 2003, pp. 33–4.

tion occurred with the repeal of the United Kingdom's corn laws in 1846. A period of relative prosperity for British agriculture followed.¹⁰¹ An international review of case studies where protection has been removed is needed to help allay over-exaggerated fears of adjustment. That same review could consider the appropriateness or otherwise of adjustment assistance. The question of adjustment assistance is a vexed one. It warrants careful scrutiny because of the high possibility that it would be captured by vested interests who want compensation. Then there is the impossible task for governments to reconcile the 'needs' of different producers. As Banks and Tumlrir remind us, 'the competing claims of producers on resources can be reconciled only by *consumers*, as Adam and Smith recognized so long ago'.¹⁰²

Nominate a date to go to free trade in agriculture

When countries first lodged their proposals on agriculture with the WTO as part of the Doha round of trade talks, the United States submitted its proposal in two parts. The first part aimed for a certain amount of reduction in each of the three pillars of agricultural policy — export subsidies, domestic support and market access. The second part focused on the longer term. The United States proposed, paraphrasing loosely, that countries should nominate the date by which they would be prepared to eliminate all trade distorting support to agriculture. But this good proposal has not received any formal consideration in the Doha negotiations, even though the idea has merit in that it makes clear which countries are prepared to liberalise agriculture, if at all, and over what timeframe. Countries should

¹⁰¹ Stoeckel 2000.

¹⁰² Banks, G. and Tumlrir, J. 1986, *Economic Policy and the Adjustment Problem*, *Thames Essay No. 45*, Report for the Trade Policy Research Centre, London, p. 75.

be asked to formally notify the WTO of the date by which they are prepared to eliminate trade distorting domestic support. The value of this exercise is that it focuses on the goal of where negotiations should end up rather than the measuring progress by looking backwards at where we have come from. The backwards looking approach can make announced tariff cuts look generous — as the World Bank¹⁰³ says, ‘great for the headlines’ — when, in reality, if average tariff cuts are chosen, there may be no real progress at all. If the goal is clear, performances in achieving that goal is easier to evaluate.

Debunk preferential access for developing countries

Preferential access for developing countries was shown to be a dangerous route. Not only do such preferences create the perverse incentive to block further liberalisation, they are often not in the best interests of developing countries. Preferential arrangements are a particularly bad mechanism for transferring aid and they help engender a victim mentality that discourages developing countries from removing their own barriers to trade. Many NGOs fuel this notion. Until the TPRM is placed on a better footing and NGOs, developing countries and rich countries alike are educated about trade policy, it would be beneficial for the World Bank to undertake a short term review of the impacts on both developing countries and the world trading system caused by preferential access for developing countries. Importantly, the review must take account of all secondary or economy-wide effects of these policies.

¹⁰³ World Bank 2004, *Global Economic Prospects: Realizing the Development Promise of the Doha Agenda*, Washington DC, p. 92.

Include ‘consumer benefits’ in anti-dumping assessments

The next change that could be done quickly is to enhance anti-dumping laws by including just two key words in the anti-dumping injury test — ‘consumer benefits’. Assessing consumer benefits along with the costs to industry would balance assessments and neutralise one of the most virulent areas of protection in the world today. When it comes to assessing claims of dumping, the world does not use best practice.

Focus on the rules first, not the organisational shortcomings

After the failure of the ministerial meeting in Cancun, attention was directed towards deficiencies in the WTO, such as the authority of the Director-General and the workability of rule-making by consensus. Questions about resourcing and the setting of priorities across different areas also arose. Splitting the stewardship of the organisation into two three year terms under two people instead of the usual six year term under one person was a mistake in hindsight. But, even with the most powerful person in the world heading the WTO, countries simply will not liberalise trade if they do not want to.

The central theme of this study is that the best way to get countries to see that it is in their interests to liberalise is through economy-wide analysis of trade policies under ‘due process’. This approach changes mindsets and the politics of protection for the better. The deficiencies in the institutional arrangements (the ‘rules of the game’) are the source of the current problem, rather than shortcomings in the organisation that administers the rules, the WTO.

There are helpful and worthwhile changes that could be made to the WTO itself. But the danger is that their

elaboration will make them the priority. People may incorrectly be lured into believing that these organisational 'fixes' will solve the problem, distracting attention from the necessary institutional changes. This would set back long term reform.

Establish an expert group

The purpose of this report has been to highlight the problems of the WTO trading system, their origins and what might be done. But change will not happen unless some 'flesh is put on the bones' of the arguments presented here. Further, these arguments need to be 'owned' by officials and ministers in the various capitals of the world in order to have the greatest effect in liberalising trade.

One proven approach would be to establish a representative expert group, tasked with fleshing out these arguments and elaborating the way forward. An expert group along the lines of the Leutwiler group, which was established prior to the Uruguay Round, should be established. At the time, the Leutwiler group had a major influence on policy formation (see appendix) and many of its recommendations were adopted. An expert group established today would think through the issues raised in this report as well as others not covered.

Hold a series of informal meetings

Finally, to secure ownership of the way forward by key trade ministers and officials, a process of informal meetings has to be established. Again, there is a successful precedent here. Stoeckel and Corbet¹⁰⁴ describe how, in retrieving the GATT system from collapse in the early 1980s, an 'informal' roundtable meeting was held at Ditchely Park

¹⁰⁴ Stoeckel and Corbet 2002, p. 9.

just before the 'crisis' GATT ministerial meeting of November 1982. The Ditchley Park meeting was attended by ministers from eighteen governments. It led to seven follow-up roundtable meetings of trade ministers, senior officials, business leaders and independent experts from different parts of the world. These meetings aimed to return to the GATT's first principles in order to prevent its collapse. The informal meetings had a favourable effect on the progress of events, helping to crystallise issues, insert 'outside' ideas into policy-making circles and promote thinking on the strengthening of the GATT system as a whole. The meetings contributed to consensus building at the inter-governmental level in formal GATT deliberations. There is merit in repeating this exercise.

In summary, to repair the WTO system and place it on a solid foundation, the main remedy is to revamp the TPRM exercise to include independent, open, economy-wide analysis of each country's trade policy. These reviews have to be done systematically and repeatedly. This approach has been highly successful in changing the politics of protection for the better in some countries. But it takes time.

Meanwhile, the nine simple and straightforward steps outlined here will pave the way for institutional repair of the WTO system in the long term, as well as advancing the short term agenda of trade liberalisation.

APPENDIX

A1 Summary of Leutwiler recommendations and outcomes

| <i>Recommendation</i> | <i>Outcome</i> |
|---|---|
| Trade policy should be more transparent, the cost and benefits of trade policy actions evaluated, and a 'protection balance sheet' produced | Trade Policy Review Mechanism (TPRM) established, but a 'protection balance sheet' not produced. |
| Agricultural trade should be based on clearer and fairer rules with no special treatment for particular countries or commodities. | Agriculture brought into GATT as part of Uruguay Round, but still treated as 'special' and no consistency with rules on manufactures. |
| Voluntary export restraints, orderly marketing arrangements, discriminatory export restrictions and other trade policy measures of both developed and developing countries should be brought into conformity with GATT rules. | Voluntary export restraints effectively dealt with in the Uruguay Round, although they could return. |
| Trade of textiles and clothing should be fully subject to ordinary rules of the GATT. | Success here even though the arrangements are backloaded to 2005. |
| Rules on subsidies need to be revised, clarified and made more effective. | Tighter rules on subsidies applied, but still not tight enough. |
| The GATT 'codes' governing non-tariff distortions of trade should be improved and vigorously applied. | Some progress and movement in right direction. |

(Continued over page)

A1 Summary of Leutwiler recommendations and outcomes (continued)

| <i>Recommendation</i> | <i>Outcome</i> |
|---|---|
| The rules permitting free trade areas need to be clarified and tightened up due to distortion and abuse. | Some attempt at tightening, but remains an area of growing abuse. |
| Trade policy and the functioning of the trading system should be made more open. Transparency of policies in action is required. | TPRM established, but no independent benefit-cost assessment of policy nor 'due process'. |
| Emergency 'safeguard' protection should only be provided in accordance with the rules. | Safeguards still a problem area. |
| Special treatment for developing countries in the GATT is of limited value. Developing countries should be fully integrated into the trading system. | Developing countries brought into the system, but special and differential treatment remains. |
| Trade in services should be brought into the multilateral trading system. | Successful GATS outcome from Uruguay Round. |
| GATT's dispute settlement procedures should be reinforced and improved. Third parties should use their rights to intercede when bilateral agreements break the rules. | Successful dispute settlement revamped and streamlined, but excessive resort to legalism. |
| A new round of GATT negotiations should be launched. | Uruguay Round successfully launched. |
| A permanent ministerial-level body should be established in GATT. | Ministerial body established. |
| There should be greater consistency and coherence between trade, financial and other macroeconomic policies. | Work proceeds on greater coherence of policy, but only partially successful. |

Source: Centre for International Economics, Leutwiler, F. 1987, *Trade Policies for a Better Future, the 'Leutwiler Report', the GATT and the Uruguay Round with an Introduction by Arthur Dunkel*, Martinus Nijhoff Publishers, Dordrecht, The Netherlands.

GLOSSARY

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| MFN | Most-favoured nation |
| WTO | World Trade Organisation |
| GATT | General Agreement on Tariffs and Trade |
| TPRM | Trade Policy Review Mechanism |
| NGO | Non-government organisation |
| MTN | Multilateral trade negotiations |
| FTA | Free trade agreement |
| TRIPs | Trade-Related Property Rights |
| ITO | International Trade Organisation |
| IMF | International Monetary Fund |
| GATS | General Agreement on Trade in Services |
| OECD | Organisation for Economic Co-operation and Development |
| PSE | Producer support estimate |
| GSP | Generalised System of Preferences |
| PTA | Preferential trade agreements |
| NAFTA | North American Free Trade Agreement |
| CER | Closer Economic Relations |

Termites in the Basement

To free up trade,
fix the WTO's foundations

Reform of world agricultural trade has deep political sensitivities. Part of the problem is the widespread lack of understanding of the economic gains from trade liberalisation. And part of that lack of understanding flows from the WTO rules governing the world trading system. Inconsistencies in the rules, numerous exceptions and loopholes that are exploited and just plain wrong rules have muddled thinking on trade policy. This study brings these issues together and suggests a way forward.

This publication is one of a series on trade issues published by the Rural Industries Research and Development Corporation (RIRDC) as part of their Global Competitiveness R&D program. Previous reports in this series are listed on the inside back cover. Additional copies of this publication may be obtained from RIRDC by visiting their website (www.rirdc.gov.au).



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