

# Two Perspectives on International Trade Agreements

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Recent literature on the World Trade Organization (WTO) reveals great uncertainty with regard to the organisation's objectives, agenda and legitimacy. Whereas one group praises the strengthened dispute settlement process and the legalisation of the system, others insist that the WTO remains primarily an institution for diplomatic negotiations. For the former, WTO disciplines contribute to greater transparency and predictability of market entry conditions for private agents, and they deplore the weakness of implementation. Reforms to strengthen the implementation process are in the forefront, therefore. Adjudication is the guiding principle to resolve disputes. The second group follows a very different perspective. According to them, the WTO is a forum for intergovernmental negotiations and does not confer rights, or firm market entry expectations, to private agents. Not adjudication, but arbitration should be the guiding principle to resolve disputes between member states. Whereas the former group makes a clear distinction between political negotiations which lead to agreements and decisions of the respective Councils and the judiciary which rules according to rights and obligations determined by the legal rules, the second group views negotiations as an ongoing process, with dispute settlement as a second step in this process.

This cleavage is also visible in the academic literature which analyses the functions of the WTO and its effects on trade policy of member states. Broadly speaking, we find an international law and an international organisation perspective. For the former, the WTO contributes to establishing international economic law, which governs private market transactions. WTO law has quasi constitutional functions. The latter group takes a state centric perspective. WTO is about coordinating government behaviour. It is no surprise that predictions and normative recommendations can vary quite substantially between these two groups. The fact that one finds both perspectives in the legal, economic and political science literature with their respective traditions of discourse makes a meaningful discussion even more difficult. Sometimes, one is tempted to describe the debate as a "*discours des sourds*". This risk is particularly pronounced if the parties do not understand their basic differences in perspectives and argue about conclusions drawn from divergent sets of assumptions.

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This essay is an attempt to structure the academic literature which seeks to explain objectives and functions of the WTO. It starts from the observation that governments conclude international trade agreements in order to reap some sort of benefits from transnational co-operation. If there were no such benefits, governments would continue to make unilateral decisions. While this sounds straightforward, it is not easy to identify what exactly the benefits of an international trade agreement are. Several explanations have been offered in the trade literature, both from an economic and from a law perspective. We find it useful to categorise them into two distinct approaches. The first approach emphasises the consequences of an international trade agreement for the relationship between a government and its national economic and political constituency. While economists and international lawyers stress different aspects, a common denominator is that the agreement is understood as a device that restricts the government's possibilities for future discretionary actions. In other words, the government commits to a liberal trade policy in face of its national constituency. We term this understanding of international trade agreements the "commitment approach". The second approach is called the "externalities approach". While governments potentially respond to the demands of domestic special interests, intergovernmental relations become the focal point. Governments enter into trade agreements in order to limit negative consequences of foreign governments' decisions. The externalities approach highlights possible gains from co-operation between governments.

The main thrust of this paper is theoretical. By making clear the underlying perspectives, we hope to offer a structure which facilitates comparison of different approaches. But it can also guide the interpretation of existing policy proposals. This is particularly relevant for assessing the ongoing negotiations for reforming the WTO dispute settlement. The paper is structured as follows: Sections 1 and 2 develop the commitment approach and the externalities approach, respectively. Section 3 discusses recent proposals for reforming the Dispute Settlement Understanding (DSU) in light of the two perspectives. Section 4 concludes.

## 1. The Commitment Approach

As indicated above, the commitment approach explains international agreements primarily in their domestic function. They restrict future discretion of the government. But why should governments be willing to tie their hands? We find two main explanations. The first one concentrates on the quality of the political process in face of organised interest groups, the second approach stresses the difficulties for governments to formulate time consistent policies if optimal policy choices depend on adaptive behaviour of private agents.

## 1.1 The Constitutional Function of International Trade Agreements

International lawyers underline the importance of international trade agreements for the (cross-border) protection of economic property rights: Trade agreements can assume a constitutional function within each signatory state. A government has the tendency to interfere with individual property rights in order to promote other political objectives. National constitutions provide a safety valve against this behaviour, but their effectiveness can be enhanced by an international regime. Tumlr was an early protagonist of this view. He argued already in 1983 that

“The structure of international commitments which governments undertake in order to provide a stable framework for economic transactions between countries can reinforce the constitutional protection of property rights within each. The international economic order can be seen as the second line of national constitutional entrenchment.”<sup>1</sup>

He goes on to identify “a reciprocal relationship between the internationally-agreed rules and constitutional-legal systems, the former deriving their normative force from the latter but strengthening them as well”.<sup>2</sup>

Petersmann is a strong advocate of the constitutional approach in later writings. He suggests that

“The international GATT obligations [...] can serve as a ‘constitutional constraint’ on the exercise and protectionist abuse of the broad discretionary trade policy-powers which, in most States, parliaments have found necessary to delegate to the executive branch; and they can thereby promote non-discriminatory trade competition also within the domestic economy and protect citizens against an arbitrary taxation and income redistribution through selective trade protection.”<sup>3</sup>

Just as there are more than 100 multilateral and bilateral international treaties that explicitly protect human rights, international trade agreements could be interpreted as an instrument to promote human rights in the economic sphere.<sup>4</sup>

Proponents of a constitutional function of international trade agreements among international trade lawyers feel assured by the institutional changes that have taken place with the establishment of the WTO in 1995. Petersmann reasons that “[t]he transition from GATT 1947 to the WTO offers so far the most successful

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<sup>1</sup> Tumlr, *International Economic Order and Democratic Constitutionalism*, ORDO, Vol. 34 (1983), 71-83 (80).

<sup>2</sup> Tumlr, *Conception of the International Economic and Legal Order*, *The World Economy*, Vol. 8 (1985), 85-87 (87).

<sup>3</sup> Petersmann, *Trade Policy as a Constitutional Problem*, *Aussenwirtschaft*, Vol. 41 (1986), No. II/III, 405-439 (407 et seq.).

<sup>4</sup> See Petersmann, *Human Rights and the Law of the World Trade Organisation*, *Journal of World Trade*, Vol. 37 (2003), No. 2, 241-281. A good overview on the pertinent issues regarding the interface between trade regulation and human rights is provided by Cottier, *Trade and Human Rights: A Relationship to Discover*, *Journal of International Economic Law*, Vol. 5 (2002), No. 1, 111-132.

example for the ‘constitutionalisation’ of a worldwide organisation [...]”.<sup>5</sup> This statement is supported by the perception that the WTO has become a “law-harmonising institution”.

There remains the question why a government should need external pressure to implement liberal trade policies which are in the economic interest of their domestic constituencies. Here, a public choice view on policy formulation may help. Public choice literature emphasises that highly concentrated special interests have better access to governments and politicians than dispersed interests. In the purely domestic realm, we see typically concentrated producer interests to confront dispersed consumer interests. In trade policy, interest representation is better balanced. Access to foreign markets is only available if one concedes reciprocal domestic market access. This means that producer interests from exporting and import competing industries are directly confronted.<sup>6</sup>

A central implication of a substantive constitutional role would be the so-called “direct effect” of international trade norms. This includes the right of economic individuals to file a trade-related complaint, either domestically or possibly at the WTO Dispute Settlement Body. The panel in *US – Sections 301-310 of the Trade Act of 1974*, WT/DS152/R, argues in Para. 7.72 that “[n]either the GATT nor the WTO has so far been interpreted by GATT/WTO institutions as a legal order producing direct effect”. Nonetheless, there is a broad academic discussion on its desirability,<sup>7</sup> with the most prominent advocates being the late Jan Tumlir and Ernst-Ulrich Petersmann.

Notable criticism with regard to direct effect of WTO law comes, however, from Jackson. First, it is not ensured that international trade law is developed by sufficiently democratic procedures: “Some constitutions provide for very little democratic participation in the treaty-making process: for example, by giving no formal role to Parliaments or structuring the government so that control over foreign relations is held by certain elites.”<sup>8</sup> Second, there is some legitimate need to translate international law to the peculiarities of national law systems. Third, there is the risk that too much bindingness of trade agreements reduces the readiness of

<sup>5</sup> Petersmann, *Constitutionalism and WTO Law: From a State-centered Approach Towards a Human Rights Approach in International Economic Law*, in: Kennedy/Southwick (eds.), *The Political Economy of International Trade Law*, Cambridge 2002, Chapter 2, 51.

<sup>6</sup> A summary of the early public choice literature is provided in Hauser, *Foreign Trade Policy and the Function of Rules for Trade Policy Making*, in: Dicke/Petersmann (eds.), *Foreign Trade in the Present and a New International Economic Order*, Fribourg 1988, 18-38. Roesler, *The Rationale of Reciprocity under Floating Exchange Rates*, *Kyklos*, Vol. 31 (1978), Fasc. 2, 258-274, discusses the reciprocity norm of trade negotiations in a public choice setting.

<sup>7</sup> Cottier/Shefer, *The Relationship Between World Trade Organization Law, National and Regional Law*, *Journal of International Economic Law*, Vol. 1 (1998), No. 1, 83-122, provide a good analysis.

<sup>8</sup> Jackson, *Status of Treaties in Domestic Legal Systems: A Policy Analysis*, *American Journal of International Law*, Vol. 86 (1992), 310-340 (323).

governments to engage in international co-operation.<sup>9</sup> Howse and Nicolaidis also doubt that the legitimacy of the WTO would be enhanced by transforming the WTO into a “federal” constitutional system. They argue instead that there is a need for greater democratic contestability, achieved by more deference to substantive domestic regulatory choices and to other international regimes that represent human values with respect to social, environmental or other standards.<sup>10</sup>

Although direct effect of WTO law as the ultimate realisation of the constitutional approach has become a minority position, there is a strong school of scholars who emphasise the role of international agreements to restrict discretionary powers of governments – which is at the heart of the commitment perspective.

## 1.2 International Trade Agreements as Solution to Time-Consistency Problems

Restricting discretionary powers of governments can be beneficial even if one assumes benevolent governments whose decisions are not constraint by biased interest group representation as has been assumed in the previous paragraph. This has been concisely formulated for the first time by Kydland and Prescott. They argue that

“Even if there is an agreed-upon, fixed social objective function and policymakers know the timing and magnitude of the effects of their actions, discretionary policy, namely, the selection of that decision which is best, given the current situation and a correct evaluation of the end-of-period position, does not result in the social objective function being maximized.”<sup>11</sup>

The time consistency problem has been first formulated with regard to monetary policy. If the central bank announces its plans to follow a restrictive monetary policy in order to reduce inflation, the costs of this policy depend very much on the subsequent behaviour of private agents. If employers and unions settle on wage contracts which embody higher expected inflation rates than envisioned by the central bank, monetary authorities are faced with an uneasy choice: Either the central bank sticks to its intentions and causes high adjustment costs or monetary policy is adjusted to inflation expectations of private agents. An optimal policy in period two might demand frustrating earlier policy choices which will discredit future policy announcements. The problem of time consistency has its roots in the

<sup>9</sup> The economic facets of this argument are discussed in Hauser/Roitingger, Renegotiation in Transatlantic Trade Disputes, in: Petersmann/Pollack (eds.), *Transatlantic Economic Disputes*, Oxford 2003, 487-506.; Rosendorff/Milner, *The Optimal Design of International Trade Institutions: Uncertainty and Escape*, International Organization, Vol. 55 (2001), No. 4, 829-857; Rosendorff, *Stability and Rigidity: The Dispute Settlement Procedure of the WTO*, Mimeo 2001, June.

<sup>10</sup> Howse/Nicolaidis, *Enhancing WTO Legitimacy – Constitutionalisation or Global Subsidiarity?*, Governance, Vol. 16 (2003), No. 1, 73-94.

<sup>11</sup> Kydland/Prescott, *Rules Rather than Discretion: The Inconsistency of Optimal Plans*, *Journal of Political Economy*, Vol. 85 (1977), No. 3, 473-491 (473).

inability of political institutions to bind themselves for future periods which exposes sequential decision making to the risks of strategic behaviour of private agents.

For trade policy, Matsuyama presents a three-stage model in which the government can maintain or reduce the protection of an industry.<sup>12</sup> In stage one, the government announces its intention. The industry decides on investments for restructuring in stage two. The government implements its trade policy in stage three. The problem of time-inconsistency can be described as follows: While the government might wish to reduce protection and announces its intention in stage one, the industry could refuse to respond with the required restructuring, hoping that the government changes its mind once it realises that the industry is unprepared for liberalisation. In this case, the industry could be compelled to launch the restructuring process only if the government was unable to deviate from its first-stage announcement. Agricultural policy in most industrial countries seems to be an obvious example of such strategic behaviour. A variant model with a similar time-inconsistency problem is provided by Staiger and Tabellini<sup>13</sup>, who consider the case where the government has incentives to surprise the private sector after a negative shock by providing more protection than expected. The private sector correctly anticipates these incentives, causing the government to implement an excessive level of protection.

Following Kydland and Prescott, who conclude that economic performance can be improved by relying on some fixed policy rules<sup>14</sup>, the government in Matsuyama's and Staiger's and Tabellini's models is in need of a device that enhances its trade policy credibility in the face of private actors.<sup>15</sup> This could be achieved by an international trade agreement that envisages liberalisation and punishes non-compliance. As a consequence, the government could credibly announce its liberal trade policy, i.e. the industry would not doubt the government's determinedness.

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<sup>12</sup> Matsuyama, Perfect Equilibria in a Trade Liberalization Game, *American Economic Review*, Vol. 80 (1990), No. 3, 480-492.

<sup>13</sup> Staiger/Tabellini, Discretionary Trade Policy and Excessive Protection, *American Economic Review*, Vol. 77 (1987), No. 5, 823-837.

<sup>14</sup> Kydland/Prescott (note 11).

<sup>15</sup> Related credibility problems that are not discussed in our paper can be found, *inter alia*, in Lapan, The Optimal Tariff, Production Lags, and Time Consistency, *American Economic Review*, Vol. 78 (1988), No. 3, 395-401; Staiger/Tabellini, Rules and Discretion in Trade Policy, *European Economic Review*, Vol. 33 (1989), 1265-1277; Maskin/Newberry, Disadvantageous Oil Tariffs and Dynamic Consistency, *American Economic Review*, Vol. 80 (1990), No. 1, 143-156; Tornell, Time Inconsistency of Protectionist Programs, *Quarterly Journal of Economics*, Vol. 106 (1991), No. 3, 963-974.

### 1.3 Commitment and Government's Objective Function

The previous two paragraphs argue why social welfare could be enhanced by restricting government's discretion. Credible commitments reduce interest group pressure and contribute to increased time consistency of sequential decisions. Yet, it is far from clear that politicians actually want to be bound. Elster argues that "in politics, people never try to bind themselves, only to bind others".<sup>16</sup> The literature on the political economy of international trade replaces the maximisation of social welfare by an objective function of the government that reflects the self-interest of the incumbent government.<sup>17</sup> In the notation of the seminal contribution by Grossman and Helpman<sup>18</sup>, this objective function takes the form

$$G = \beta W + (1 - \beta) \sum_{i=1}^n C_i$$

with  $W$  representing social welfare,  $C_i$  being the political contribution of (the politically organised) sector  $i$ , and  $\beta \in [0,1]$  illustrating the weight that the government attaches to social welfare, relative to political contributions. Political contributions can consist, for example, of financial means used for electoral campaigns or simply for signalling the government's ability as a fund-raiser.

In short, governments can derive benefits from political contributions of special interests, which in turn depend on the possibility to influence trade policy outcomes. As Maggi and Rodríguez-Clare put it: "[...] a government may prefer to leave the door open to [...] domestic pressures rather than foreclose them" because "[it] ends up at least as well off in the political equilibrium as under free trade."<sup>19</sup> Therefore, the two authors attempt to identify the parameters that determine whether a government is likely to look for a commitment device.

For that purpose, they consider a small-country, two-sector model where capital is immobile in the short run but mobile in the long run. Only one industry is able to form a lobby. Within this general theme, they point out that the government's interest in an international trade agreement mainly depends on two factors. First, the stronger the bargaining position of the government (which is notably absent in the Grossman-Helpman model) in the face of lobbies is, the less likely is the government to enter a trade agreement. The reason is obvious: A strong position of the government helps to extract large rents from the private sector, which is attrac-

<sup>16</sup> Elster, *Ulysses Unbound*, Cambridge 2000, ix.

<sup>17</sup> This literature is surveyed by Magee/Brock/Young, *Black Hole Tariffs and Endogenous Policy Theory*, Cambridge 1989; Hillman, *The Political Economy of Protection*, Chur 1989; Weck-Hannemann, *Politische Ökonomie des Protektionismus*, 1992; Magee, *Endogenous Protection: A Survey*, in: Mueller (ed.), *Handbook of Public Choice*, 1994; Rodrik, *Political Economy of Trade Policy*, in: Grossman/Rogoff (eds.), *Handbook of International Economics*, Amsterdam 1995, 1457-1194; Grossman/Helpman, *Interest Groups and Trade Policy*, Princeton 2002.

<sup>18</sup> Grossman/Helpman, *Protection for Sale*, *American Economic Review*, Vol. 84 (1994), No. 4, 833-850.

<sup>19</sup> Maggi/Rodríguez-Clare, *The Value of Trade Agreements in the Presence of Political Pressure*, *Journal of Political Economy*, Vol. 106 (1998), No. 3, 574-601 (576).

tive for the government, given that the government is not only benevolent (i.e.  $\beta < 1$  in the Grossman-Helpman notation). This result, however, is somehow paradox in predicting that countries with strong (import-competing) lobbies and correspondingly weak governments are more likely to enter an international trade agreement!

The second factor is the government's responsiveness to political contributions, relative to social welfare (measured by  $\beta$ ). Given that its bargaining power is relatively low, the incentive to join an international trade agreement varies in a non-monotonic fashion. If the responsiveness is low (i.e. the government is benevolent), there will be little distortion and there is no need for joining an international trade agreement from a commitment perspective. If, at the other extreme, the government cares a lot about political contributions, it will not forgo them by signing an agreement. Therefore, only if the government cares significantly about both social welfare and political contributions will it conclude an international trade agreement.

Note that a low level of actual commitment in international trade relations does not necessarily imply that the commitment approach has little explanatory power: Although a successful binding of hands would make a government resistant to interest group pressure *ex post*, this pressure might be all the more strong in the run-up to the conclusion of an agreement, preventing governments from making far-reaching commitments. In fact, the negotiated extent of commitments need not crucially differ between the scenario in which governments do not want to have their hands bound in the face of domestic interest groups and the alternative scenario in which they would like to be bound *ex post*, but are impeded from concluding a respective agreement due to *ex-ante* interest group pressure. Empirical findings on a low bindingness of agreements would therefore be unable to determine the explanatory power of the commitment approach.

Staiger and Tabellini, in contrast, show some empirical evidence suggesting that international trade agreements indeed help governments to make domestic trade policy decisions that they could not have made in the absence of these rules.<sup>20</sup> They refer to the Tokyo Round of GATT negotiations (between 1974 and 1979), where governments negotiated in a first step across-the-board tariff reductions and then went on to exclude certain product categories from these general formula cuts. A government that is unable to credibly commit to a trade policy before the relevant production decisions by the private sector are made would not consider the implications on production distortions when selecting these exclusions, since it cannot influence the production decisions anyway. If, however, the rules of an international trade agreement such as the GATT indeed helped governments to make (unpleasant) policy decisions at home, we would expect, all else equal, that departures from the general formula cuts are smaller in sectors where these departures have a particularly substantial distortive effect. Bagwell and Staiger provide

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<sup>20</sup> Staiger/Tabellini, Do GATT Rules Help Governments Make Domestic Commitments?, Economics and Politics, Vol. 11 (1999), No. 2, 109-144.

evidence that the United States indeed granted departures less readily in sectors where higher tariffs were more likely to have significant welfare implications.

Despite these (and some other) advances, the commitment approach is still not fully recognised in the economic interpretation and evaluation of the multilateral trading system.<sup>21</sup> The majority of economists tend to prefer another explanation for international trade agreements, namely the internalisation of negative cross-border externalities.

## 2. The Externalities Approach

### 2.1 Economic Externalities

In its early formulations, the externalities approach started from the assumption that governments seek to maximise national social welfare, i.e. they are benevolent. From the perspective of an individual government, this requires the setting of positive (“optimal”) tariff rates whenever a tariff is able to reduce the export price of foreign suppliers (i.e. whenever the foreign export supply is not perfectly elastic). The price reduction improves the domestic terms of trade, and thus enhances welfare.<sup>22</sup> Unilateral free trade would only be optimal in the case of a small country, measured in terms of its demand on world markets, for which world prices are given.

However, if all governments pursued such a “beggar-thy-neighbour” policy, the resulting equilibrium in tariff rates would not be efficient any more; a prisoner’s dilemma would emerge. In a prisoner’s dilemma, a government sets tariffs in order to improve the domestic terms of trade, but since foreign governments do the same (they “retaliate”), the terms of trade eventually remain unchanged and all countries necessarily lose as compared with free trade.<sup>23</sup> Social welfare could be increased if tariffs were abolished on a reciprocal basis. Consequently, an international trade agreement eliminates negative terms-of-trade externalities.

When countries differ in their size, the case for an international trade agreement that abolishes tariffs is somewhat weakened. While free trade is still the welfare-maximising outcome for the universe of countries, Johnson argues that a large country could be better off by imposing a tariff even in the case of foreign retaliation, as long as its price elasticity of import demand is larger than the correspond-

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<sup>21</sup> This opinion is confirmed by Bagwell/Staiger, *The Economics of the World Trading System*, 2002, 36.

<sup>22</sup> This has already been recognised by Mill, *Essays on Some Unsettled Questions of Political Economy*, 1844, see his chapter “Of The Laws of Interchange Between Nations; And The Distribution of The Gains of Commerce Among The Countries of The Commercial World”.

<sup>23</sup> See Scitovsky, *A Reconsideration of the Theory of Tariffs*, *Review of Economic Studies*, Vol. IX (1941), No. 2, 89-110, for an early presentation of this argument.

ing elasticity of trading partners.<sup>24</sup> Johnson's first formalisation of the terms-of-trade theory has led to numerous extensions.<sup>25</sup> Kennan and Riezman<sup>26</sup> and Syropoulos<sup>27</sup> are particularly noteworthy in that they attempt to link the demand elasticities to different characteristics of countries, such as technology, factor endowments, or consumer tastes.

The significance of the terms-of-trade externality in explaining the existence of international trade agreements need not decrease if the assumption of a benevolent government is abandoned. As argued above, the literature on the political economy of international trade replaces the maximisation of social welfare by an objective function that reflects the self-interest of the incumbent government. While the level of political support for the government need not be positively correlated with social welfare, it obviously has a potential impact on trade policy outcomes. Grossman and Helpman show in this setting that an international trade agreement again eliminates negative externalities caused by the terms-of-trade effects of tariffs.<sup>28</sup> The specific characteristics of an agreement are influenced by the relative strength of the sectoral lobbies in member countries: The lobby which has the greater stake in the negotiations (as measured by the output of its sector) and which has the less benevolent government will *ceteris paribus* achieve more domestic trade intervention than its counterparts in other countries. The relative level of trade intervention is furthermore influenced by the relative price sensitivity of import demand; the lower this sensitivity in a country, the more intervention a lobby can expect from its government.

Bagwell and Staiger go one step further and claim that the benefits of an international trade agreement in the above setting are even exclusively deter-

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<sup>24</sup> Johnson, Optimum Tariffs and Retaliation, *Review of Economic Studies*, Vol. 21 (1953), No. 2, 142-153.

<sup>25</sup> Among those that are not further discussed in this paper are Gorman, Tariffs, Retaliation and the Elasticity of Demand for Imports, *Review of Economic Studies*, Vol. 25 (1958), 133-162; Horwell, Optimum Tariffs and Tariff Policy, *Review of Economic Studies*, Vol. 33 (1966), 147-158, considering specific instead of *ad valorem* tariffs; Kuga, Tariff Retaliation and Policy Equilibrium, *Journal of International Economics*, Vol. 3 (1973), 351-366; Tower, The Optimum Quota and Retaliation, *Review of Economic Studies*, Vol. 42 (1975), 623-630, who analyses quota instead of tariff retaliation; Otani, Strategic Equilibrium of Tariffs and General Equilibrium, *Econometrica*, Vol. 48 (1980), 643-662; Riezman, Tariff Retaliation from a Strategic Viewpoint, *Southern Economic Journal*, Vol. 48 (1982), 583-593, modelling the tariff game as a prisoner's dilemma; Hamilton/Whalley, Optimal Tariff Calculations in Alternative Trade Models and Some Possible Implications for Current World Trading Arrangements, *Journal of International Economics*, Vol. 15 (1983), 323-348; Dixit, Strategic Aspects of Trade Policy, in: Bewley (ed.), *Advances in Economic Theory*, Cambridge 1983; Bagwell/Staiger, A Theory of Managed Trade, *American Economic Review*, Vol. 80 (1990), No. 4, 779-795.

<sup>26</sup> Kennan/Riezman, Do Big Countries Win Tariff Wars?, *International Economic Review*, Vol. 29 (1988), No. 1, 81-85.

<sup>27</sup> Syropoulos, Optimum Tariffs and Retaliation Revisited: How Country Size Matters, *Review of Economic Studies*, Vol. 69 (2002), 707-727.

<sup>28</sup> Grossman/Helpman, Trade Wars and Trade Talks, *Journal of Political Economy*, Vol. 103 (1995), No. 4, 675-708.

mined by the elimination of terms-of-trade externalities.<sup>29</sup> In the tradition of the Grossman-Helpman model, the government takes into account political concerns when formulating its trade policy. Each government's utility is represented as a general function of the local and world market prices that any particular tariff selection implies. The difference between local and world prices can satisfy redistributive purposes both between countries and within each country. In order to prove their claim, Bagwell and Staiger consider a hypothetical world in which governments are not motivated by the terms-of-trade implications of their trade policy and show that in such a world, unilateral tariff choices are efficient. Therefore, the terms-of-trade externality is the only rationale for an international trade agreement under a political-economy perspective. In other words, while political concerns increase the realism of the model, they do not offer any separate explanation for a trade agreement.

Yet, there are at least three problems with the asserted relevance of the terms-of-trade argument for international trade agreements. Firstly, there are small countries (defined in respect of their demand share on world markets) which have high tariffs, although they are not able to affect foreign export prices. Many developing countries could be cited as examples. On the other hand, there have always been large countries deciding unilaterally not to set welfare-maximising ("optimal") tariffs. However, if tariff levels were regularly not related to terms-of-trade considerations, how should the latter explain the reduction of the former by means of an international trade agreement?

The second problem is even more puzzling: If international trade agreements really cared about the elimination of terms-of-trade externalities, they would be expected to prevent countries from implementing export taxes. Such taxes raise the price of domestic exports, improving the terms of trade. However, as Ethier rightly argues, the GATT has no single provision that prohibits governments from raising the price of domestic exports.<sup>30</sup> In particular, Article II (Schedules of Concessions) and Article III (National Treatment) explicitly address only import restrictions. And Article XI (Elimination of Quantitative Restrictions) explicitly exempts export taxes. While one could argue that the GATT is silent on the export tax issue because no government wants to tax domestic exports anyway, this again raises doubts as to the significance of the terms-of-trade argument in trade policy considerations. Or, as Ethier puts it: "The Received Theory [on the importance of the terms of trade] is a truly magnificent accomplishment ... There is just one problem. The Received Theory is simply irrelevant to actual multilateral trade agreements."<sup>31</sup>

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<sup>29</sup> See Bagwell/Staiger (note 21), 18-32; Bagwell/Staiger, GATT-Think, NBER Working Paper 2000, No. W8005, 12-20; Bagwell/Staiger, An Economic Theory of GATT, American Economic Review, Vol. 89 (1999), No. 1, 215-48.

<sup>30</sup> Ethier, Political Externalities, Non-discrimination, and a Multilateral World, PIER Working Paper 2002, No. 02-030, 2.

<sup>31</sup> Ibid.

The third problem is nurtured by recent findings of Rose.<sup>32</sup> In his analysis of world trade flows, he employs a standard gravity model of bilateral trade. Such models explain cross-border trade with the distance between countries and their joint income. Rich countries close to each other are *ceteris paribus* expected to have a higher bilateral volume of goods exchange than poor countries that are located far away from each other. Rose augments the basic gravity equation with a number of additional conditioning variables that have a presumable effect on trade, e.g. culture, geography and history. In this setting, he shows that membership in the WTO (or in the GATT, respectively) has not been associated with enhanced trade once the other explanatory variables are taken into account. This empirical finding suggests that even if the terms of trade were relevant, a formal agreement such as the WTO (or the GATT) may not be necessary to eliminate their negative externalities.

While Bagwell and Staiger attempt to rebut some of these arguments,<sup>33</sup> the critique with regard to the explanatory power of the terms of trade has led authors to search for other motives behind the conclusion of international trade agreements.

## 2.2 Political Externalities

Recent political-economy literature using formal models has combined domestic political objectives with gains from external co-operation. As Ethier notes, a trade agreement serves governments to get credit for the reduction in foreign trade barriers. International co-operation is not about the elimination of economic externalities, but about political externalities.<sup>34</sup> The latter arise when politicians in one country believe that their political status is directly affected by actions of politicians of another country.

Ethier's argument is in the tradition of earlier contributions that have stressed the importance of an exchange of reciprocal market access commitments.<sup>35</sup> The ra-

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<sup>32</sup> Rose, Do We Really Know that the WTO Increases Trade?, NBER Working Paper 2002, No. 9273.

<sup>33</sup> See Chapter 11 of Bagwell/Staiger (note 21), which is entitled "The Practical Relevance of Terms-of-Trade Considerations".

<sup>34</sup> Ethier (note 30); Ethier, Trade Agreements Based on Political Externalities Mimeo 2003, August.

<sup>35</sup> See e.g. Roessler (note 6); Finger, Protectionist Rules and Internationalist Discretion in the Making of National Trade Policy, in: Vosgerau (ed.), *New Institutional Arrangements for the World Economy*, 1988, 310-323; Hauser (note 6); Moser, *The Political Economy of the GATT*, 1990; Finger, *The GATT as an International Discipline Over Trade Restrictions*, in: Vaubel/Willett (eds.), *The Political Economy of International Organizations*, 1991, 125-141; Hillman/Long/Moser, *Modelling Reciprocal Trade Liberalisation – The Political-economy and National-welfare Perspectives*, *Swiss Journal of Economics and Statistics*, Vol. 131 (1995), No. 3, 503-515; Hillman/Moser, *Trade Liberalization as Politically Optimal Exchange of Market Access*, in: Canzoneri/Ethier/Grilli (eds.), *The New Transatlantic Economy*, Cambridge 1996, Chapter 10.

tionale is explained most easily by comparing the consequences of an international trade agreement with those of unilateral liberalisation. In the latter case, a government would be blamed by the import-competing industry for the rising level of imports. At the same time, it would not get any political support from the export industry, even if foreign governments also liberalised unilaterally; the direct connection between reduced domestic barriers and improved access to foreign markets would not exist. In the case of a trade agreement, in contrast, the blame of the import-competing industry could be offset by the credit that the government gets for having opened up foreign markets. Indeed, governments regularly praise an international trade agreement for its creation of additional export opportunities. On the other hand, they are silent on the (politically sensitive) aspect of domestic market opening, although economic theory shows that liberalisation at home is responsible for substantial social welfare gains.

Note that this political-economy approach is compatible with a high level of contingent protection that seems to be the mirror image of the tariff reductions achieved in multilateral negotiation rounds.<sup>36</sup> Obviously, governments can derive some benefits from protection, and they might resort to temporary means once permanent (i.e. long-term) import barriers have to disappear. However, why would they agree to abandon permanent barriers if they seemingly did not want to give up protection? A possible explanation could run as follows: The multilateral reduction of permanent protection is a signal *à la* Ethier that export interests play an important role in the strategy of the government (“look, we have opened up foreign markets for you”). At the same time, however, the government satisfies import-competing sectors by the prospect of temporary relief. While this strategy could finally provoke a protectionist foreign response, there is no clear-cut connection. Therefore, domestic exporters may not blame their government for reactions of foreign governments.

### 2.3 Incomplete Contracting<sup>37</sup>

Viewed from the externalities perspective, governments conclude trade agreements to co-ordinate their behaviour in order to minimise external economic or political costs. It is important to note that such contracting must necessarily be incomplete. The optimal response would be dependent on the future course of all those variables which enter the objective function of governments. For terms-of-trade effects, such variables would include shifts in relative supply and demand, technological advance, or changes in market structure. Political costs include changes in the organisation and/or concentration of special interest groups, elec-

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<sup>36</sup> The high level of contingent protection is first and foremost due to intensive antidumping actions, see e.g. Roitinger, Preserving Trade Policy Flexibility in Antidumping Reform, *Aussenwirtschaft*, Vol. 58 (2003), No. III, 353-81.

<sup>37</sup> This paragraph draws heavily on Hauser/Roitinger (note 9).

tion cycles, or changes in political majorities. Finally, the relative weight a government attaches to political contributions compared to social welfare might change. Such diversity of factors and the uncertainty characterising their development make it impossible to write an international agreement that anticipates the future and makes all actions (or prohibitions of actions) contingent on the evolvement of these variables. From a government perspective, any agreement is therefore characterized by too much rigidity; the concessions are not made sufficiently dependent on the future state of the world. Rigidity is one of two distinct forms of incomplete contracting, the other one being discretion.<sup>38</sup>

In such a world, a contract asking for detailed specific performance is most probably not the optimal response. In private contracting, we observe two typical reactions to great uncertainty: Relational contracting, or, if parties go into dispute, (implicit) use of the concept of efficient breach of contract. In relational contracting, parties agree less on specific performance, but on a governance structure which ensures ongoing co-operation and a fair distribution of the gains from co-operation.<sup>39</sup> The concept of efficient breach of contract takes into consideration that specific performance of a contract might not be a welfare enhancing solution.<sup>40</sup> If the advantage of a breach of contract is larger than the cost to the affected party, compensation is welfare improving compared to specific performance. Both, the focus on governance structures in relational contracting and on compensation as an alternative to specific performance coming from the literature on efficient breach of contracts are important elements for understanding the functioning of international trade agreements.

### 3. Implications for the Analysis and Reform of the WTO Dispute Settlement System

Sections 1 and 2 have a theoretical orientation. They offer two perspectives which help to position the different strands of discussion. The commitment approach defines international agreements mainly from their domestic function. They restrict discretionary powers of governments and contribute to policies which are less prone to being captured by specialised interest groups and can (partially) overcome the problem of time-inconsistencies. Within the externalities ap-

<sup>38</sup> See Battigalli/Maggi, Rigidity, Discretion and the Costs of Writing Contracts, *American Economic Review*, Vol. 92 (2002), No. 4, 798-817 (798).

<sup>39</sup> Macneil, Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neo-classical and Relational Contract Law, *Northwestern University Law Review*, Vol. 72 (1978), 854-901, provides an early thorough discussion of the differences between classical and relational contract law.

<sup>40</sup> See Schwartz/Sykes, The Economic Structure of Renegotiation and Dispute Resolution in the WTO/GATT System, *Journal of Legal Studies*, Vol. 31 (2002), No. 1, 179-204; Sykes, The Remedy for Breach of Obligations under the WTO Dispute Settlement Understanding: Damages or Specific Performance?, in: Bronckers/Quick (eds.), *New Directions in International Economic Law*, The Hague 2000, 347-357, for the concept with an application to WTO dispute settlement.

proach international agreements serve primarily the function of co-ordinating state behaviour and, thereby, of containing the risk of negative external effects in the international realm. But the two concepts are not only useful instruments for structuring the theoretical discussion; they have also far-reaching consequences for evaluating the debate about the reform of the WTO Dispute Settlement Understanding. We will first concentrate on some fundamental issues and then highlight selected questions from the ongoing negotiations in the Doha-Round framework.

### 3.1 Adjudication or Arbitration

The most fundamental question refers to the legal quality of the dispute settlement process. Should it be viewed as adjudication which defines legal rights and obligations of the parties and gives precision to the legal texts (and ventures into law making), or, are we to interpret the dispute settlement process as structured arbitration?<sup>41</sup> The first view is supported by the legalised structure of dispute settlement, especially the court like proceedings of the Appellate Body. The weak disciplines for enforcing implementation and the flexibility of the parties to negotiate mutually acceptable solutions without direct interference from third parties speak for the second interpretation.

We find proponents for both views in the legal discipline. Cottier, amongst many, is one of the leading scholars who support the adjudication perspective.<sup>42</sup> WTO law creates rights and obligations for countries which they can bring to the dispute settlement process in case of violation. The fact that violation of WTO law is treated as *prima facie* evidence for nullification or impairment of benefits accruing to members under the covered agreements, also speaks for a legalistic interpretation of the treaties.

A minority of legal scholars is more sceptical, though. Charnovitz questions the supremacy of the WTO sanctioning mechanism over soft law approaches which derive their strength not from punishment but from underlying value systems (human rights, core labour standards).<sup>43</sup> Nettesheim's voice is even more sceptical.<sup>44</sup> He holds the strong view that WTO law should not be interpreted in light of the necessity to protect fundamental freedoms and individual rights. The

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<sup>41</sup> Nettesheim, Legitimizing the WTO: The Dispute Settlement Process as Formalized Arbitration, *Rivista Trimestrale de Diritto Pubblico* 2003, 711-729, formulates this question openly.

<sup>42</sup> Cottier/Takenoshita, The Balance of Power in WTO Decision-Making: Towards Weighted Voting in Legislative Response, *Aussenwirtschaft*, Vol. 58 (2003), No. 2, 171-214, propose that the perceived imbalance between a strong dispute settlement system and a weak political decision process should be corrected not by weakening the adjudication but by strengthening political decision processes by introducing majority voting between rounds.

<sup>43</sup> Charnovitz, Rethinking WTO Trade Sanctions, *American Journal of International Law*, Vol. 95 (2001), No. 4, 792-832; Charnovitz, *Trade Law and Global Governance*, London 2002, Cameron May.

<sup>44</sup> Nettesheim (note 41).

WTO has no provisions to resolve value conflicts which emerge with the increasing tendency to extend market entry disciplines to “behind the border” measures (particularly TBT, SPS and TRIPS agreements). In his analysis, the tension between the normative vagueness of the WTO provisions in case of a conflict between trade and non-trade objectives and its institutional setting of dispute resolution is at the core of the legitimacy conflict. Any attempt to sharpen the dispute settlement procedure and to give more teeth to the implantation process would be counterproductive, therefore. He pleads for conceptualising the dispute settlement process as formalized arbitration and not as adjudication.<sup>45</sup>

Closely related to this discussion is the controversy over the hierarchy of dispute remedies. The majority of legal scholars support the interpretation that Article 22:1 of the DSU formulates a clear hierarchy of remedies: Full implementation is preferred over compensation, which again is preferred over suspension of concessions.<sup>46</sup> But again, there are diverging views, with Schwartz and Sykes being the most prominent authors.<sup>47</sup> According to them, compliance, offering of compensations and accepting retaliation are equally acceptable means of restoring the original balance of rights and obligations.

It is obvious that the two perspectives set out in Sections 1 and 2 have a close analogy to the foregoing debate on the legal status of the dispute settlement process. The commitment approach emphasises defined legal rights and obligations and specific performance in case of conflict. The externality approach highlights the state centric view and the need for flexibility if one concedes that co-operation agreements must necessarily be incomplete. Arbitration is then a better approximation to the functions of the DSU than adjudication. We are not legal scholars and must leave it to the experts to discuss to what extent objectives and basic functions of an agreement are interpretative tools. If they are, we should first have a thorough discussion along the lines formulated in this paper before we can draw conclusions on the future direction of reform for the DSU.

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<sup>45</sup> Another strong voice for flexibility and against a legalistic approach is Barfield's. See Barfield, *Free Trade, Sovereignty, Democracy. The Future of the World Trade Organisation*, 2001.

<sup>46</sup> Jackson, *The WTO Dispute Settlement Understanding – Misunderstanding on the Nature of Legal Obligations*, *American Journal of International Law*, Vol. 91 (1997), No. 1, 60-64, is a good reference.

<sup>47</sup> See Schwartz/Sykes (note 40); Sykes (note 40).

### 3.2 A Selected Commentary on the DSU Reform Process<sup>48</sup>

In 1994, even before the DSU had entered into force, a separate “Ministerial Decision on the Application and Review of the Understanding on Rules and Procedures Governing the Settlement of Disputes” was adopted. It called upon Ministers to complete a full review within four years after the entry into force of the agreement and to take a decision whether to continue, modify or terminate the dispute settlement rules and procedures. The deadline was missed and the DSU review was put back on the agenda again as part of the Doha mandate, intended to be included into early harvest in 2003. Again, the deadline was missed and extended, and there are still no signs of agreement.

A multitude of substantive and procedural proposals have been introduced by the WTO member states during this process.<sup>49</sup> The “Chairman’s text” of 28 May 2003, named after the Chairman of the negotiations Péter Balás, incorporates many of these proposals and was meant to serve as a basis for agreement. However, portions of the text are still bracketed (which indicates disagreement between the parties) and, more important, many of the more controversial proposals have been left out.

For the present purpose it is useful to concentrate on the more contentious issues. They include, for instance, several elements of a proposal by the United States and Chile on “improving flexibility and member control in WTO dispute settlement”. Obviously motivated by a series of defeats in trade remedy cases and a surge of criticism of WTO dispute settlement from US Congress, it would have allowed the deletion of findings in panel or Appellate Body reports by mutual agreement of the parties. Furthermore, it would have provided for the partial adoption of panel and Appellate Body reports only, and it called for “some form of additional guidance to WTO adjudicative bodies”. A majority of small and medium-sized trading nations refuse any increase of political control, as this would automatically benefit the more powerful members.

Another proposal that was not taken into account is the EU call for a permanent panel body. Whereas panellists are usually government officials or other trade specialists who are appointed ad hoc and discharge their tasks as panellists on a part-time basis and in addition to their ordinary duties, the EU wants to establish a roster of 15 to 24 full-time panellists. The EU hopes that this would lead to a professionalisation of the panel process. Opponents of the proposal argue that members of a permanent panel body could be more “ideological” and might engage in law-making. They therefore feel more comfortable with the current system as it draws

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<sup>48</sup> This paragraph draws heavily on Zimmernann, *What Direction Should the DSU Take? Negotiations and Proposals to Review and Reform the WTO Dispute Settlement Understanding*, Dissertation Universität St. Gallen, forthcoming, Bamberg 2004; Hauser/Zimmernann, *The Challenge of Reforming the WTO Dispute Settlement Understanding*, *Intereconomics*, Vol. 38 (2003), No. 5, 241-245.

<sup>49</sup> Zimmernann (note 48), chapter 6 and 7, provides a detailed account of all proposals which have been introduced until 2003.

heavily on government officials who are familiar with the constraints faced by governments.

This is a very selective list, but it illustrates fundamental disagreement over the objectives and functions of the WTO agreements which make consent very difficult. There are those who call the existing dispute settlement process too weak – motivated primarily by the difficulties to implement rulings of Panels and Appellate Body –, and we find those who object to the “law making tendencies” of the Appellate Body. We suggest that these differences are very akin to our distinction between commitment and externalities approaches. Again, a thorough discussion on the objectives and functions of the WTO agreements is a necessary precondition for success.

#### 4. Conclusions

We find strongly diverging views on the objectives and functions of the WTO in general and its dispute settlement process in particular. Their recommendations are difficult to compare because they start from different assumptions. We propose that the discussion is easier to follow if one accepts two basic perspectives. The commitment perspective concentrates on the domestic function of international agreements. Tying ones hand can be a useful device to strengthen the government’s position against special interest groups. The protection of market access rights of private agents is an important objective, and asks for binding rules for the formulation of trade policies. The externalities approach is state centric and discusses trade agreements as co-ordinating devices to minimise negative effects of foreign decisions on domestic governments (or welfare). They are best conceptualised as incomplete contracts which formulate principles of governance and not necessarily specific duties. Dispute settlement is not primarily about specific performance, but more about keeping the balance of rights and obligations. Reciprocity becomes an important norm not only in the negotiations of new agreements but is also an important principle for guiding the resolution of disputes.

We have refrained from making explicit statements as to which perspective is better suited to guide reforms, and we think we should not do so. Both perspectives have their merits and the decision which one to use is heavily dependent on basic value judgements. A more intensive open discourse is asked for. If this discourse should transcend disciplinary boundaries, legal scholars will have to pay more attention to the externalities concept and economists should go beyond their state centric view to integrate hierarchical co-ordination of legal concepts.