C THE DESIGN OF INTERNATIONAL TRADE AGREEMENTS

In Section B we discussed a range of reasons why nations may share an interest in cooperating with one another in trade matters. In this section we extend the analysis to examine fundamental issues of treaty design, focusing on two main questions. First, what are the core rules that any good trade agreement must contain so as to reap the envisaged benefits from cooperation? Second, how does the creation of a formal organization (or institution) ensure the effectiveness of rules and foster the objectives of an agreement?

The Section begins (Section 1) by asking why institutions[1] may be needed along with the rules that make up an agreement. We then go on to examine what specific rules trade agreements must have to realize the benefits of cooperation. Among the principal rules discussed here are those on reciprocal liberalization (Section 2), the preservation of gains from market access commitments (Section 3), contingency protection (Section 4), enforcement (Section 5), and transparency (Section 6). International trade agreements typically include more rules than these, but we have selected those we consider to be among the most important. Relevant provisions in GATT 1994, the WTO Agreement and regional trade agreements will be used to illustrate the expression of these rules.

1. THE ROLE OF INSTITUTIONS

Signatories to trade agreements typically confer some authority on an independent agent in the belief that a neutral or internationalized body is more effective in governing trading relations than the signatories themselves. In what follows, we shall attempt to link institutional necessity back to the earlier discussion of the various rationales for trade agreements. We start with a discussion of how well theories of trade agreements and theories of institutions match. Economists focusing on the purpose of trade agreements have typically assumed away the very reasons why institutions are needed. We need to reconcile the established (politico-economic) models of trade cooperation with explanations for the existence of institutions. These models can be enhanced so as to identify a range of functions for an independent institution administering trade affairs, such as a repository of knowledge, an archivist, a provider of research and trade assistance, an information gatherer and disseminator, a negotiation forum, a mediator, a facilitator, a monitor, a surveillance agent and an adjudicator.

Moreover, from an international relations (IR) perspective formal institutions may be more than just a site for international cooperation or passive facilitators of trade. As active and independent agents in the international system, institutions can also shape expectations and thereby influence the behaviour of parties. They can help to establish the basis for orderly and constructive trade negotiations and actively manage cooperation. Multilateral institutions can also foster peaceful relations among countries, thereby creating the general conditions for profitable exchange through trade.

(a) Matching theories of trade agreements with theories of institutions

Until relatively recently, economics paid little attention to international rules and institutions for the conduct of trade policy.[2] But starting in the 1990s, different strands of trade agreement literature have gone beyond a narrowly-drawn analysis of incentives driving trade policy preferences, and have focused more on issues such as the rationale for trade agreements, substantive obligations, and enforcement mechanisms. So far, however, attempts to integrate work in these various areas have been limited. Models that focus on the rationale for trade agreements are typically "institution-free" – that is, they have little to say about the role of an independent third party in trade agreements. Models focusing on the need for formal trade institutions, on the other hand, oftentimes fail to establish an explicit and systematic link

[1] The term "institution" is understood here to refer to a formal institutional body. Note that international relations scholars and international lawyers sometimes use the term differently. There, an "institution" may denote a regime, a political system or a legal provision.

[2] See Staiger (1995).

back to the rationale of an agreement underlying the institutional model. In this subsection and the next we will show how theories of trade agreements and theories of trade institutions can be reconciled, and will review the relevant literature.

Reconciling analytical approaches to the rationale for trade agreements and for trade institutions is not an easy task, largely because theories on trade agreements assume away the very reasons for having an institution.[3] Most formal models of trade cooperation rest on a set of simplifying assumptions. Box 4 summarises these assumptions.

Box 4: Commonly utilized assumptions in externality-models of trade cooperation

Formal models of trade cooperation (at least in their simplest form) maintain the following set of simplifying assumptions:[4]

Assumption (i) – Game set-up:
The "trade game" is modelled as an infinitely repeated prisoners' dilemma between equally powerful (symmetrical) actors.[5]

Assumption (ii) – Maximum mutual deterrence:
Cooperation is sustained by the "shadow of the grim trigger". Parties mutually threaten to punish any kind of defection by ceasing cooperation indefinitely and returning to non-cooperation (protectionism).

Assumption (iii) – Unchanging circumstances ("stationarity" of the environment):
External circumstances are assumed to remain unaltered throughout the course of the agreement. The models are non-dynamic in their approach to trade; changes in environmental conditions, such as technological innovations, demand or supply shocks, or special interest group pressure are not expected to occur.

Assumption (iv) – Symmetrical information:
All players (trade-policy decision-makers) have the same information at the outset of the negotiations as well as at any point in time during the game. Information about the environment, trade-related policies and Members' intentions ("types") are immediately known by all parties.

Assumption (v) – Rationality:
All "players" (i.e. negotiators) possess complete rationality and sophistication. They are fully forward-looking, self-interested utility maximizers.[6]

Assumption (vi) – No transaction costs:
Negotiations, trade flows, and disputes are cost-free and frictionless.[7]

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3 Economic theories have made assumptions that minimize the role for trade institutions since their goal was to highlight the logic of agreements. This was made for analytic convenience rather than motivated by the firm belief that institutions do not matter.

4 Note that these assumptions do not underlie any motive for trade cooperation, but only externality-based rationales for trade, as reviewed in Section B, subsections 2.(a) and (b) (see footnote above).

5 Bagwell and Staiger (2002: 40) note an overwhelming consensus in the literature that "trade agreements may be formally analyzed using a theory of repeated games". This undoubtedly applies in the terms-of-trade and political externalities schools of thought, which rely on the prisoner's dilemma as the key rationale for cooperating (see e.g. Bagwell and Staiger,1999a, 2002; and Ethier, 2004, 2006).

6 This assumption does not suggest that all economic actors are perfectly rational. The political-externality approach to trade agreements, for example, sometimes rests on the assumption that domestic importers are "bounded rational" and give more weight to the direct effects of trade policy (see Ethier 2004).

7 Transaction costs are real-life costs of interaction between actors (here: trade negotiators). Strictly speaking, the presence of transaction costs is not an additional assumption, but rather a consequence of the combination of unlimited rationality and stationarity of the environment. Nothing is lost, however, in treating transaction costs as an independent assumption.

Under these commonly utilized assumptions listed in Box 4, the simple models reviewed in Section B cannot justify the existence of an institution.[8] Take the example of the terms-of-trade approach to trade agreements, as elaborated in Section B.2.(a), which models multilateral agreements as infinitely repeated prisoners' dilemma games between equally powerful (symmetrical) actors. Reciprocal tariff cuts are enforced through the mutual threat of responding to any contractual defection with an immediate and complete withdrawal of cooperation. This is the so-called "grim trigger" response to deviation.[9] This model setup, although beneficial in highlighting the rationale for trade cooperation (overcoming an opportunistic externality problem), brings with it three important consequences.

First, an international trade agreement is viewed as what can be called a "fully efficient contract". It is a perfect contract that exhausts all possible gains from trade and therefore never needs to be altered, revised, amended, or renegotiated.[10] The agreement represents a stable negotiation equilibrium that never needs to be renegotiated.

Second, given that the original agreement is both perfect and stable, neither deviations nor applied sanctions ever occur. This is so because under grim-trigger enforcement, rational parties would defect only if their "hit-and-run" advantage (the opportunistic gains achieved from a one-time defection at the expense of other parties) is larger than the sum of all future pay-offs from eternal cooperation. Hence, owing to the "shadow of the grim trigger", once the agreement is concluded deviation from the original terms of the agreement is not rational – and therefore never occurs. In other words, there is no room for disagreement and trade disputes. Consequently, neither the parties nor an independent institution have to be concerned with them.[11]

Third, trade cooperation emerges as an "endogenous negotiation equilibrium". The contract is a tacit agreement (Dixit 1987) that is concluded and maintained without the outside help of any third party. Welfare-maximizing cooperation emerges spontaneously. As a result, there is no room for an institution. A secretariat or a directorate would involve costs and yield no benefits. In their most basic form, therefore, economic theories disregard imperfections that may occur during the contracting phase (i.e. before the contract is signed) and during the performance phase of a trade agreement.[12] But the superfluity of institutions within this framework is belied by the fact that formal institutions do exist.

From an economic standpoint, an institution is viewed as an equilibrium outcome of a game of strategic interaction (North, 1990). This means that the presence of an institution should not be assumed, but must be an outcome of a model of interaction. An institution is therefore part of multiple possible bargaining outcomes – or equilibria, and is chosen because it provides contracting parties with distinct benefits that could not have been reaped otherwise (Calvert, 1995; Schotter, 1981). In other words, given that institutions are costly to establish and sustain, their existence must yield a higher level of welfare to the signatories than the *status quo*.

Models of institutions take into consideration imperfections that the establishment of a formal organization can overcome, or at least mitigate. Matching theories of trade agreements with theories

8 It should be pointed out that not all of the above assumptions (i)-(vi) are required concurrently or additively to reach this conclusion. Some formal models have been developed in which players use a punishment strategy different from the maximal grim-trigger strategy, face changing circumstances, or have private information. Papers of this kind then assume that actors are able to coordinate sufficiently on an equilibrium outcome without using the outside help of institutions.

9 Enforcement of trade agreements is discussed in Section C.5 below.

10 A fully efficient contract is also known as a "complete", or "Pareto-optimal complete contingent" contract in the literature. A contract of this sort provides a complete description of every possible state of nature, and prescribes in detail all rights and obligations of each contracting party, including the set of policy instruments that parties may or may not use. The fully efficient contract thereby exhausts all possible gains from trade – it is the first-best contract between trade partners (see Shavell 1980).

11 If trade disputes do in fact occur, they are equivalent to the breakdown of the system.

12 To be sure, the terms-of-trade argument has been formally extended beyond the simple version introduced in Section B. It is the only approach that formally links the discussion of the purpose of trade agreements with a discussion of the rules and obligations of trade agreements. But this "workhorse" model of trade agreements has not yet been formally extended so as to motivate formal institutions.

of trade institutions requires a systematic and structured approach. While staying within the confines of the externality-driven rationale for trade agreements, we will now consider how this framework can be modified successfully in order to explain the need for institutions. Although this attempt at fusion is a far cry from moulding a unified whole, it seems a useful first step in linking institutions back to the rationale for trade cooperation.

(b) Expanding the traditional models of trade cooperation: the economics of institutions in trade agreements based on externalities

Trade institutions can contribute to facilitating negotiations, enhancing transparency and settling trade disputes.

(i) The presence of transaction costs: the institution as negotiation forum, information disseminator, and trade facilitator

"Transaction costs" is used as a general term here for all those real-life costs that states must incur when they cooperate internationally in trade matters.[13] Such costs include sorting and searching costs, information gathering costs, bargaining costs, as well as litigation, enforcement and policing costs. By assuming the function of a negotiation and dispute forum, an information disseminator, and trade facilitator, an institution reduces transaction costs.

The institution as a forum for negotiations and disputes

During ongoing trade rounds, or during negotiations with accession candidates, transaction costs may be substantial. Costs include the collection of trade data and institutional information about (potential) trade partners, meeting and bargaining with the parties involved until consensus is reached, assessing vantage points and shaping compromise. A central negotiation forum where parties can convene, exchange information, negotiate and take decisions is economical and efficiency-enhancing.

In the same vein, institutions can help to reduce transaction costs connected to trade disputes and litigations. Since trade disputes (renegotiation after unilateral defection) are a costly endeavour, Ludema (2001), for example, argues the case for a single body. Instead of having to renegotiate/litigate bilaterally in multiple fora and according to different procedures (so-called "forum shopping"), it is rational to deal with disputes in a centralized fashion.

The institution as information repository

Once transaction costs are taken into consideration, a second role for an independent trade institution emerges. Consistent with a strand of international relations literature called "neoliberal institutionalism" (usually associated with the works of Keohane, 1984, and Oye, 1986 – see Section B.4 above), there is a strong case to be made for the informational role of the institution. By acting as an "institutional memory" – storing, archiving, retrieving, editing, processing and publishing crucial information – the institution reduces transaction costs and increases transparency.[14] This vital information may be too costly for every country to generate and process alone. Even if that were not the case, and Members could individually extract the same data, unnecessary duplication would occur. Thus the organization helps its signatories save costs by providing accurate and timely information. Over and above the support of ongoing trade negotiations and disputes between sovereign states, the organization can also provide non-signatories with information.

[13] Early work on transaction costs dates back to Coase (1937) and Williamson (1979; 1975).

[14] Institutions collect and make available information on Members, sectors, multilateral processes and rules, current negotiations and ongoing litigation. Thus, in addition to activities such as translation and duplication, the organization routinely provides background data and summarizes negotiating positions in order to provide a basis for further negotiations.

The institution as trade facilitator

"Opening the books" to non-state agents not only satisfies the claims of the private sector to remain informed about the activities of governments. In addition, providing information to economic actors can reduce transaction costs of international trade through technical assistance. By explaining the intricacies and implications of the trade agreement to various stakeholders in signatory countries (customs officers, importers, exporters, consumers, chambers of commerce, industry associations, etc.), the organization can effectively function as a trade facilitator. Information and analysis may be transmitted, for example, through publication on the internet, public symposia, and seminars. In cutting the transaction costs of international trade in this manner, the institution will be contributing to human capital formation and may also be promoting trade by reducing the prices of goods and services.

(ii) Questioning the "grim trigger" assumption of enforcement: the institution as honest broker and conciliator

Many formal models of trade cooperation assume that enforcement against contractual misdemeanour involves the maximum possible punishment – that is, the grim trigger strategy of enforcement.[15] Some authors have questioned whether one-time defection really leads to a complete breakdown of the system, thus challenging assumption (ii) above. The argument is that a victim's threat to cease cooperation forever is not credible. The grim trigger strategy is too costly to apply and uphold. By returning to protectionism, the punishing victim foregoes sizeable gains from international trade. Hence, the victim country has an incentive to return to the negotiation table in order to access the benefits of future cooperation (Downs and Rocke, 1995; Klimenko et al., 2002; Furusawa, 1999). With this knowledge, parties may have an incentive to deviate from the terms of the original agreement, hoping that such behaviour does not trigger a trade war.

In order to forestall this kind of opportunistic behaviour and the detrimental dynamics it may entail,[16] a neutral "external legal institution" may be empowered to act as a conciliator or "honest broker" (Thompson and Snidal 2005), whenever a defection from the terms of the initial agreement occurs. Klimenko et al. (2002) show that this neutral body must be vested with the authority to rule and that parties must not be able to exert undue influence on its verdict.[17] Importantly, dispute resolution will occur with a delay, implying time costs (lost cooperation) that parties cannot control. While the dispute settlement body has no actual enforcement power over countries, its ability to delay judgement and to impose (*ex ante* unknown) costs on both parties can serve as a credible punishment.[18] The institution as conciliator forces parties to make a trade-off between undisturbed beneficial cooperation and costly

[15] A few formal models may count as exceptions here: Ethier (2001); Rosendorff (2005); Rosendorff and Milner (2001); Herzing (2004); and Bagwell and Staiger (2005a). Some models assume the possibility of escape clauses, i.e. contingency rules where one-time deviation for exceptional reasons is tolerated (see subsection 4 below on contingency).

[16] Note that if the grim trigger response is a non-credible threat, the dominant strategy for all countries may be to (partially) defect from the initial agreement. This can prevent the contract from being concluded in the first place.

[17] To be sure, dispute settlement need not necessarily be carried out by a formal dispute settlement institution. Other signatories to the agreement who are not involved in the dispute could take over this task – given they are independent and neutral. However, in a repeated-game setting with a limited number of actors, neutrality can be assumed to wane over time.

[18] In this model, absent a neutral body, countries would not resolve the dispute among themselves, as they would always renegotiate disciplines to restore cooperation more quickly. In the words of the authors, "external enforcement is valuable precisely because the countries are unable to manipulate the parameters of the enforcement process". (Klimenko et al., 2002: 4). Countries would always be back at square one. The authors reject approaches that explicitly link renegotiation outcomes to the history of policy choices. They cast doubt on the assumption of reduced bargaining power of the defecting country, or the existence of smaller sets of possible agreements following defections (as assumed, for instance, by Ludema, 2001). They contend that bargaining power is history-invariant and that only independent dispute settlement will help countries condition their agreements and future policies on past actions.

trade disputes. Hence, the mere presence of a neutral dispute settlement agent provides parties with an a priori incentive to honour commitments.[19]

Robert Keohane (1984) also questions the relevance of the grim-trigger punishment scenario in repeated games. The longer successful trade carries on, the expectations of signatories will converge. Reciprocity (characterized by contingency protection and equivalence in retaliation) can effectively replace grim trigger responses when players trust each other. A neutral dispute settlement institution can help to achieve and maintain that trust in the system.

(iii) The presence of asymmetric information: the institution as information disseminator and monitor

The presence of private (asymmetric) information is another factor that provides a role for an independent trade organization. In this case, the institution acts as a provider of information and an agent for surveillance. Sometimes, countries depart from their commitments on account of "special circumstances" envisaged in an agreement (Articles XIX, XX or XXI of the GATT may count as examples in relation to trade contingency). However, in contrast to the assumption of symmetrical information maintained in traditional trade cooperation models (see Assumption (iv) above), parties are often asymmetrically informed about whether or not these special circumstances have really occurred and to what extent they would justify a temporary departure from obligations.

Opportunistic behaviour may occur if the party concerned stands a chance of not being discovered (Copeland, 1990). This party is better informed than those affected by the action, for whom it is difficult or impossible to assess conclusively whether or not the alleged event (e.g. a balance-of-payment crisis) has occurred and if so, whether it is covered as a valid exception in the agreement. Private information about contingency conditions may lead to strategic misrepresentation and consequently to disputes which can spiral out of control if countries retaliate and counter-retaliate.

In the presence of asymmetric information, and the subsequent danger of strategic misrepresentation of reality by the better informed party, a neutral dispute settlement body can inject additional transparency into the system by acting as a disseminator of information. Once aware of being affected by a contract infringement, parties can proceed to self-enforce their claims. Thus, the institution facilitates the enforcement of negotiated agreements through providing parties with relevant information.[20]

Closely connected to the role of an institution as information disseminator is that of a monitor of trade affairs. Potential injurers, aware of being monitored by a "trade watchdog", are less likely to deviate. The institution can deter defections against agreed-upon rules of trade, thereby contributing to an environment of stability in international trade. By effectively discouraging defections, institutions are apt

[19] The value of a lengthy (and therefore costly) adjudication process in trade disputes is also derived by Ethier (2001) and Reinhardt (2000) – albeit for different reasons. Both authors see the institution as a "tool" rather than an agent. Ethier assumes that parties are able to punish a defection instantaneously, but choose to delay instead. Lengthy procedures provide for an unsanctioned breather (temporary escape) during which an injurer can de facto violate the agreement without punishment. Reinhardt sees the DSU as a mechanism to maintain bilateral uncertainty over the actual enforcement power of the institution. Due to this uncertainty, lengthy adjudication procedures (high transaction costs) increase the chances that international conflicts end cooperatively in a mutually agreed settlement. A speedy ruling is counterproductive, since the lack of uncertainty over the ruling motivates parties to settle early according to present power relationships. By contrast, Ludema (2001) and Kovenock and Thursby (1992) argue that lengthy procedures are a disadvantage of dispute settlement.

[20] See Maggi (1999), Kovenock and Thursby (1992), Hungerford (1991), Ozden (2001), Bütler and Hauser (2002), and Bagwell and Staiger (2002, Chapter 6) for an elaboration of the information gathering and transmission role of an institution in trade disputes. In the field of institutional economics, the role of institutions as information providers to uninformed parties has long been recognized and documented. The literature on law merchants, for example, explains a system of neutral intermediaries within merchant guilds in medieval Italy. Law merchants acted as information repositories for traders (notably on each other's credentials) who had never interacted before. They thus supported cooperation through facilitating the use of a bilateral reputation mechanisms and multilateral enforcement (e.g. Milgrom et al., 1990, Greif et al., 1994).

to facilitate liberalization negotiations and to reduce power asymmetries among parties (Bagwell and Staiger, 2002: 39).

(iv) Trade agreements as incomplete contracts: the institution as active information gatherer, adjudicator, arbitrator, and gate-keeper of the rules of the game

It has been repeatedly pointed out that trade agreements are incomplete contracts.[21] If the assumption of an unchanging environment (and hence complete certainty about future events) is relaxed (Assumption (iii) in the last subsection), uncertainty over future contingencies will then reflect incompleteness of the contract. Based on a methodology developed by Battigalli and Maggi (2002), Horn et al. (2005, 2006) show that in a dynamic, non-stationary world it is both rational and efficient for contracting parties to deliberately leave contractual gaps in a trade agreement and to refrain from writing a fully contingent contract. In this way, governments accept uncertainty over future conditions in the world and possible policy responses that may prove desirable.[22]

Textual ambiguities, for instance, may then lead to inefficiencies, misunderstandings, disputes and, possibly, the need to re-negotiate. Whereas under subsection (iii) above the institution functions as an information broker that balances informational asymmetries in the system, the case is different here. Whenever the contract is incomplete, an independent institution may be called upon to actively gather information (not just to distribute it). In addition, since not all relevant situations have been foreseen, an independent adjudicator may have to interpret the contract (unless or until a new negotiated solution is reached) in a manner that supposedly corresponds to how the contracting parties would have wanted it, had they anticipated the situation. When contract incompleteness is coupled with private revelation of information,[23] the institution may also function as an arbitrator and calculator of damages. If uncertainty over the future is allowed by relaxing the assumption of perfect rationality of trade negotiators, yet another function of the institution emerges, namely that of a gate-keeper of the rules of the game.

The need for an information gatherer

Whereas in subsections (i) and (iii) above the role of an institution as an information repository and disseminator was considered, a neutral body can also act as an active information gatherer if the assumption of an unchanging environment (and hence complete certainty about future events) is relaxed. Consider the example of dispute settlement. Hungerford (1991) models uncertainty over future events as random import demand impacts (exogenous shocks). Asymmetrical information emerges in the form of non-observable non-tariff barriers (NTBs). In a contracting environment, where exogenous shocks disrupt trade flows, but where each party has an incentive to defect by secretly enacting NTBs, the institution as an independent dispute settlement body can support members by extracting information about the true nature of an observed outcome. It can find out whether an external shock has indeed occurred (in response to which the NTB may be legitimately taken) or whether the Member in question has instead enacted a prohibited NTB.[24] That way, the information gatherer helps to limit undesirable (and unfair)

21 See Dunoff and Trachtman (1999), Downs and Rocke (1995), Rosendorff and Milner (2001), Ethier (2001), Rosendorff (2005), Hauser and Roitinger (2004), Horn et al. (2006).

22 According to the authors, trade agreements can be called "rationally incomplete contracts". The transaction costs involved in researching, writing and bargaining over treaty obligations and permitted policy instruments under the full range of possible environmental conditions simply make contractual completeness impractical. The costs involved outweigh the potential gains from trade. This is typically the case with complex contracts that feature a large number of low-probability contingencies, as well as a great variety of possible responses to such events. The major contribution of Horn et al. (2005, 2006) is that the authors endogenously derive contractual uncertainty over future events – and consequently the incompleteness of the contract – without having to give up the assumption of rationality. Even rational parties find it too difficult to anticipate, evaluate and write down every possible detail that the future may bring.

23 Uncertainty over future contingencies is often coupled with private information. In reality, previously unforeseen contingencies are privately revealed to some parties (this is tantamount to dropping Assumption (iv) above).

24 Kovenock and Thursby (1992: 167) ascribe a similar role to independent dispute settlement as a "device that distinguish[es] between true deviations ... and mistaken perceptions ... that such a deviation has occurred". However, like Hungerford (1991) the authors do not specify how a neutral body manages to extract such information and why it would do a better job than the affected parties themselves.

punishments by providing crucial evidence to those affected by a measure. This prevents the system from spiralling into a retaliatory trade war and secures higher initial liberalization commitments.[25]

The need for an arbitrator and calculator of damage awards

In case of uncertainty and asymmetric information, an institution may fulfil yet another role. Unforeseen events may prompt a signatory to adapt to the new context by enacting an appropriate domestic policy (say, a health measure or a tariff increase). This – legitimate or illegitimate – trade-related policy causes adverse effects on affected parties. If the latter were always able to observe the occurrence of the conditions that have led one party to defect and to monitor the effects of the measure it has taken in response, they could in principle agree *ex ante* on commensurate (tit-for-tat) punishments (Sykes, 1991; Ethier, 2001). If this simple rule of punishment were followed, the implementation of such a temporary escape measure would not necessarily require the presence of an independent dispute settlement body (Downs and Rocke, 1995; Rosendorff and Milner, 2001).[26] Yet several authors ascribe a role for the institution even if all parties possess the same knowledge about unforeseen events, arguing that since the ultimate punishment can only be determined *ex post,* the involvement of a neutral entity is required.[27]

In effect, it is likely that the damage caused by trade-related policies of partner countries cannot be assessed unambiguously. Some authors contend that the size of trade damages suffered is often private information to the victim(s). Both the conditions leading to temporary defection and the resulting damages cannot be observed by all parties alike (Herzing, 2004; Bagwell and Staiger, 2005a). Parties affected by a measure are likely to overstate the damage caused. Dissent will follow from a mismatch between the damage claimed and the compensation offered. In the presence of asymmetric information and the incentive to misrepresent the true state of affairs, a neutral body is needed to arbitrate between the disputing parties and to calculate the true damages suffered as the result of a measure (Sykes, 2000; Schwartz and Sykes, 2002; Rosendorff 2005).[28]

The need for an adjudicator

When negotiating the design of dispute settlement, negotiators are aware that they cannot foresee all future contingencies. They therefore create provisions that allow them to respond adequately to previously unforeseen circumstances. Two problems remain, however. First, as discussed above, safety valve provisions allowing parties to respond to unforeseen circumstances are often difficult to operationalize. In many instances it is not clear whether a contingency has occurred, whether the event falls under the ambit of an escape clause or whether specific policy measures taken violate the terms of the agreement. Second, in addition to these "efficiency gaps" created by contractual fallback rules, treaties may contain inadvertent gaps (Mavroidis, 2007; Ethier, 2001; Lawrence, 2003; MacLeod, 2006). Parties make errors when negotiating complicated contracts: They omit crucial details, write down contradictory clauses or neglect the dynamic effects of their regulations. In addition, contracting parties may agree on terms that are subject to interpretation, such as "appropriate countermeasures", "serious injury", "material damage", "unforeseen developments", "like products" or "best efforts".

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25 Parties would likely be willing to make more far-reaching trade liberalization commitments if they do not risk to punishment for adapting to external shocks. Equally, potential victims are more likely to make greater commitments if a neutral body deters other parties from defecting at their expense.

26 In other words, an unconditional escape clause emerges endogenously at the outset of the negotiations of a trade agreement. Both the possibility to react flexibly to political and economic shocks, and the voluntary payment of commensurate compensation for damages incurred emerge as a negotiation outcome.

27 Ethier (2001) specifies lengthy dispute settlement procedures. Rosendorff requires a sufficient level of uncertainty as to the direction of the ruling in order to ensure certain costs are incurred from using an escape clause. Arguably, this requirement is necessitated more by mathematical constraints than economic intuition (Rosendorff, 2005: 398).

28 Interestingly, Kaplow and Shavell (1996) find that an independent arbitrator need not be omniscient or operate flawlessly. As long as its judgement is not systemically biased, the organization's verdict will be acceptable to parties (see also Rosendorff, 2005). Most models do not make the distinction between the bilateral enforcement remedy of (voluntary) compensation and multilaterally endorsed retaliation. For a notable exception see Bown (2002).

Some may argue that whenever parties leave contractual gaps (including when they use ambiguous language) they cease to be "rational" (as assumed in theoretical models of trade agreements – Assumption (v) above). Seen from this perspective, an independent body may always be required to adjudicate, where possible, or else parties may have to renegotiate. However, Tirole (1994) warns against giving up the assumption of rationality in the absence of a theory of "bounded rationality". The author contends that any theory of bounded rationality and human error should be able to specify when errors occur, why they occur and what the consequences are. He rejects an "errors happen" approach as arbitrary and unscientific.[29] Horn et al. (2005, 2006) derive the role for institutions adjudicators even without giving up the central tenet of rationality. Thus, as in the previous two subsections, under the assumptions of uncertainty and asymmetrical information, contracting parties are conscious of their incapacity to write a complete and flawless contract. Signatories know that the contract cannot be enforced as written, since its text does not fully correspond with what they actually want. The contracting parties are also aware of the fact that private information may provoke strategic misrepresentation of the truth, and consequently opportunistic behaviour.

The presence of uncertainty and private information creates the potential for conflicts that can be dealt with in two ways. Either parties agree to disagree about the true state of the world and its applicability to the contract. The victim party (which may or may not be a "true" victim) may decide to take unilateral measures of reprisal, usually referred to as "vigilante justice" or self-help mechanisms. If the targeted party is convinced that its original measures were in line with the initial agreement and therefore feels wrongly accused and punished, this party may counter-retaliate. The dispute may set off a downward spiral of mutual reprisal and end in a trade war situation (Schwartz and Sykes, 2002). Alternatively, rational contracting parties (if they do not renegotiate) may wish to defer the solution of conflicts regarding adherence to obligations to an independent dispute settlement body and commit to accepting its rulings. Interpretations rendered by such an institution may be accepted as precedents and general guidelines for the future.

The institution as a surveillance agent and "gate-keeper" of rules

If uncertainty over the future is allowed by relaxing the assumptions of stationarity of the environment and perfect rationality of trade negotiators, yet another role emerges for the institution, namely that of a gate-keeper of the rules of the game. In the presence of uncertainty over the future, countries can then be assumed to negotiate the details of a trade agreement "behind a veil of ignorance" (Rawls 1971).[30] The veil of ignorance will prompt contracting parties to write a trade agreement that is geared towards the common general welfare of all signatories to the agreement, since no party knows with certainty its position decades down the road (Sykes 1991, Ethier 2001). Under the influence of the veil of ignorance the trade agreement is perceived *ex ante* as fair and efficient to every participant.

Signatories will then want to confer on the institution the role of a gate-keeper of the previously agreed "rules of the game". The organization acts as a surveillance mechanism that can effectively prevent countries from diluting, disregarding and reneging on the original agreement once the "veil of ignorance" is lifted and reality is exposed to the signatories. *Ex post facto,* all parties know with certainty where they stand and what is best for them. Thus, they may experience regret over the original terms of the agreement and have an incentive to skew, bend or even change the rules of the agreement to their

[29] See also Maskin and Tirole (1999). However, law and economics scholars have frequently disregarded this advice. They have taken it as "given" (exogenous) that contracting parties regularly make errors when negotiating contracts and that an adjudicating institution exists to help them remedy any unplanned situation. With quite some success this literature seeks to assess court strategies to help parties continue their contractual relations (so-called relational contracts). Unfortunately, only a few authors so far have approached international contracts (treaties) from this perspective (Bhandari and Sykes, 1998; Dunoff and Trachtman, 1999; Posner, 1988).

[30] A veil of ignorance means that contracting parties do not know the future distribution of gains and losses from an initial agreement with certainty. Negotiations among prospective signatories to a trade agreement take place in ignorance of; (i) the identity of future acceding countries; (ii) the economic significance of a country in the distant future; (iii) the role of contracting parties in future trade disputes, and (iv) generally of how future contingencies are going to impact on signatories' political and economic well-being.

benefit. In the face of significant pressure by economically and politically influential players to renegotiate or otherwise change an agreement, it may be in the founding parties' interest to instruct the institution to ensure ongoing commitment to a previously agreed rules-based negotiating environment. By keeping an eye on fixed procedures, instruments and timelines, the institution may contribute in upholding an environment of reasonably stable and secure property rights over negotiated market access claims.

This gate-keeping role of the institution will sustain confidence in the system. On the one hand, it will stimulate and facilitate ongoing liberalization rounds. On the other, it provides parties with an institutional commitment to a rules-based negotiating environment, which further reduces transaction costs of negotiating, and may encourage weaker countries to overcome their fear of exploitation by stronger trading partners and to participate in the negotiations (see Bagwell and Staiger, 2002: 69).

(v) Summary: the economics of institutions matter

The traditional politico-economic models of trade agreements confer a fleeting role to an independent, formal trade organization. Once real-life features of world trade are taken into consideration by enhancing formal trade models based on externalities, various important functions for trade institutions emerge. They can enhance transparency, serve as negotiating fora and help settle trade disputes. Trade negotiators may therefore be inclined to confer significant responsibility and authority to a formal organization.

(c) Non-economic approaches to formal institutions

The previous subsection was concerned with exploring the economic rationality behind the establishment of a formal organization in support of a trade agreement. Efficiency considerations took centre stage in explaining the existence of a neutral party to oversee international trade affairs. The discussion mainly centred around theories supported by formal models of choice. Non-economic approaches based on an IR analytical framework can also provide important insights into the question why formal institutions (international organizations in IR parlance) matter in international trade.

(i) Relative lack of research on international organizations

International relations research on international organizations (IOs) – in terms of their rationale and functioning – is surprisingly sparse. In the early post-war years, IOs (such as the United Nations) were very much at the centre of academic attention. This early work on IOs was largely legal-descriptive (Abbott and Snidal, 1998). However, given the challenge facing IOs of remaining relevant in the Cold War, researchers gradually lost interest in studying them. The gulf between international politics and formal organizations began to open in ways that were not easy to reconcile (Simmons and Martin, 2002). Organizational design and other formal attributes could not explain what IOs really did. It was clear that IOs were not the main actors in the game of international governance (Kratochwil and Ruggie, 1986). Therefore, mainstream IR turned to the conduct of international relations – regime theory – and tended to neglect questions of organization.[31]

This move away from consideration of IOs as actors resulted in a shift of emphasis towards rules, norms and values as the central variables under study (Abbott and Snidal, 1998). Questions surrounding institutional form and structure (regime design) were overlooked (Young, 1994; Koremenos et al. 2001; Morrow, 1994). Thus issues such as why IOs matter at all and what sets them apart from alternative forms of organization – such as decentralized cooperation, alliances, treaty rules, or ad-hoc contracting and informal consultation – received relatively little attention. In the words of Abbott and Snidal (1998: 4), "surprisingly, contemporary international scholarship has no clear theoretical answers to such questions".

[31] This is of course not to say that there was no academic work done on IOs during the time of the Cold War and after. The work of Cox and Jacobson in the 1970s (e.g. Cox and Jacobson, 1973) is a good example that IOs remained the subject of some serious research throughout the post-World War II era.

The regime movement represented an effort to theorize about international governance more broadly, detached from technical questions of design and organization. During the Cold War and with the continuing decline of United States' hegemony, regime theorists sought to explain why states found incentives to collaborate. Krasner's (1983) definition of regime defined as "rules, norms, principles and procedures that focus expectations regarding international behaviour" was seen as canonical and all-encompassing, but hardly workable. Hence, scholars moved on to the study of "institutions", which sought to explain more comprehensibly just how rules of cooperation affected state behaviour. To that end, the various IR schools of thought defined "institutions" in ways that suited their own research agenda and methods (Simmons and Martin, 2002).

In terms of contemporary IR theories reviewed in Section B.3, realists and neorealists recognize that states sometimes operate through institutions, but IOs are basically seen as "arenas for acting out power relations" (Carr 1964: 189). It is the most powerful states in the system that create and shape institutions so that they can maintain their share of world power or even increase it. International organizations are tools in the hands of powerful countries and have minimal influence on state behaviour (Mearsheimer, 1994). Within this analytical framework, the study of IOs as independent actors with purpose and influence would seem rather pointless.

A more nuanced neorealist account of IOs has been proposed by theorists advocating hegemonic stability. They claim that IOs are consciously established by dominant powers during periods of hegemony. In order to signal to other nations that it will not abuse the institution opportunistically, the hegemon must grant the IO a certain degree of autonomy. The definition of "institutions" advocated by hegemonic stability theory is broad, however, and can encompass anything from the establishment of a liberal economic order to the conclusion of a treaty. Moreover, it is not entirely clear what functions an IO can assume that a hegemon itself cannot fulfil.

The school of neoliberal institutionalism gives little consideration to IOs (Simmons and Martin, 2002). Cooperation in this framework is the result of a rational contract between sovereign states. Institutions – broadly understood as "persistent and connected sets of rules … that prescribe behavioural roles, constrain activity, and shape expectations" (Keohane 1989: 3) – are solutions to problems of collective action. This approach to IOs is similar to that of neorealism, for functionalists institutions play a passive role. As for facilitating interaction, they can reduce transaction costs, improve information and raise the costs of violations. This functional understanding of institutions as sites of cooperation (not as actors) precludes any sensible operational activity for IOs that may motivate their establishment, such as monitoring, arbitrating, or information provision (Glaser, 1995). Seen from the perspective of neoliberal institutionalists, then, IOs do little more than lubricate cooperative arrangements among states.

Constructivist (or cognitivist) theory, on the other hand, grants IOs a bigger role in international cooperation. As noted in Section B.3, constructivists emphasize the primacy of social construction and the complexity of interactions. International organizations are thus seen as more than purely objects of choice. They are both a reflection of ongoing social processes and prevailing ideas and participants in the shaping of those processes and ideas. Finnemore and Sikkink (1998), for example, describe IOs as "chief socializing agents" that instil states with inter-subjective meanings in the form of common norms and values. Thus, IOs "can alter the identities and interests of states as a result of their interactions over time within the auspices of a set of rules" (Simmons and Martin, 2002: 198). Despite the active role that constructivists grant to IOs, its proponents still have trouble explaining why IOs are created by countries in the first place.

Three shortcomings are highlighted in the literature. First, Checkel (1998) contends that constructivism suffers from "monocausality" – that is, it is too much focused on describing how ideas travel from the system into states, yet lacking in explanations in regard to the mechanisms and processes of social construction and diffusion. There is no clear theory of how ideas and new norms emerge in IOs, how they become salient, and how they then connect with agents (but see Lumsdaine, 1993). Second, constructivists tend to stress the impact that IOs have on individual state behaviour without explaining

why states intentionally create IOs in the first place (Kratochwil and Ruggie, 1986). Third, constructivism also tends to overlook why IOs are special arrangements for norm diffusion and in what ways they are embedded in larger systems of norms and principles, such as the liberal international economic order of the post-war period (Ruggie, 1983).

More recent mainstream IR literature has rediscovered international organizations as a worthwhile field of study, recognizing that IOs are important agents in international life that contribute substantively to unique cooperative outcomes. Contemporary research makes a conscious effort to transcend the old rifts that have characterized IR theory in the past. Striving for a synthesis of rationalist (including neorealist) and constructivist thinking, recent approaches argue that states consciously use IOs to reduce transaction costs, enhance efficiency, prepare the ground for cooperation, and monitor both the rules of the game and state actors. International organizations also create ideas, norms, and expectations, so as to deepen and fortify the aims pursued by the initial arrangement. This basket of roles and functions that IOs assume, is called "regime management" (Abbott and Snidal, 1998, Thompson and Snidal, 2005), and clearly overlaps in significant respects with politico-economic analyses of the kind described above.

(ii) The role of international trade organizations: regime management

The analytical starting point for examining any cooperative effort is the assumption that the nature of the contract is complex and a potential source of conflict. Despite sharing a common vision of why it is in the interest of all signatories to conclude a contract, negotiating parties often have heterogeneous preferences. Different countries cooperate for different reasons. Trade cooperation, in particular, is a "mixed motive game" (cf. Section B.5 above). But even when states share the same motivations, discussion over the distribution of gains is likely to arise. As a result, although every party knows that it is generally better off cooperating, various details of cooperation are subject to disagreement. This gives rise to potential conflicts and incentives to defect temporarily from the agreement.

There is also oftentimes considerable uncertainty regarding the future, contracts are necessarily incomplete and transaction costs are inevitable (see subsection 1.(b) above). In order to deal with these contractual challenges in an expeditious way, states establish international trade organizations. The main task of the organization is to manage the international trade regime so as to enhance the efficiency and legitimacy of collective actions.[32] Regime management can be broken down into various functions.

Brokering cooperation among heterogeneous partners

Thompson and Snidal (2005) contend that an important task of IOs is to "manage and stabilize the equilibrium path". The central insight is that in a complex contract heterogeneous preferences of signatories will inevitably lead to disagreement over distributional issues. And although parties know that cooperation is generally welfare-improving, they fail to settle for a specific outcome. Disagreement is likely to increase with the number of parties and issues under negotiation, and with the complexity of the contract. In order to avoid endless bargaining, or even a deadlock in negotiations, signatories delegate authority to an impartial organization that selects one welfare-improving outcome (Fearon, 1998). This coordination equilibrium is an outcome in the collective interest and mutually acceptable to every party. Box 5 provides a more technical elaboration of an institution's role in attaining the equilibrium path.

A precondition for this contribution from an IO is that it possesses a certain degree of autonomy. The IO must be considered neutral and impartial, and capable of credibly representing the collective interest of the parties (Thomspon and Snidal, 2005: 12). When brokering among heterogeneous preferences, IOs will often use strategies, such as issue linkage, agenda setting, pooling, information gathering and distribution, and incessant communication support by their specialized and experienced staff.

[32] Note that organizational form and the assigned functions of individual trade regimes may vary with the nature, identity, and level of ambition of the cooperating parties.

Trade agreements are usually "member-driven", which means that important decisions are taken by the parties as a whole. In the case of the WTO, Thompson and Snidal (2005: 20) note: "As an organization, the WTO is dominated by its member states and has only a weak bureaucracy with little agenda setting power and resources."

Manage substantive operations over time

Although the basic bargains in trade cooperation are forged by the states themselves, it is the detailed operations of the regime that give effect to them in specific circumstances. The IO is often authorized to take responsibility for the functioning of inter-governmental agreements.[33] Thus, more than brokering negotiation breakthroughs, IOs fulfil their role of regime management in a quiet, steady way. Regime management often means the implementation and operation of the cooperative equilibrium created by an agreement over time.[34] The IO is an important gate-keeper of the rules and has some control over the "path dependency" of the agreement (Thomson and Snidal, 2005: 14). The IO's actions reflect an attempt to interpret the collective cooperation equilibrium. This in turn provides vital information to parties regarding how they are expected to conform to the cooperation equilibrium – it creates and maintains shared expectations. Therefore, the IO's rule management feeds back into how parties behave and interact.

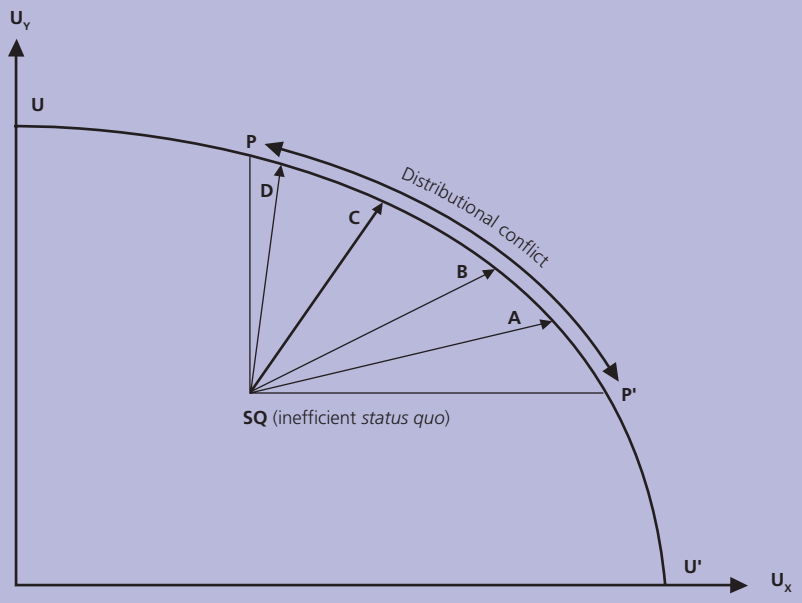
Box 5: The role of IOs in attaining the equilibrium path

In order to illustrate how IOs can help negotiating parties attain the equilibrium path in a cooperative setting, consider the following Chart. There, the utility of two countries (*X* and *Y*) is plotted on the axes (U_x and U_y). Both countries recognize that the non-cooperative *status quo* (point *SQ*) is inefficient, and that they can improve on their welfare by cooperating. Suppose the parties understand the details of the contract possibility curve *UU'* (the locus of all efficient contracts). Every point on the *PP'*-segment (corresponding to a unique cooperation outcome) is mutually welfare-improving, since every player is placed in a better position without making the other worse-off. Solutions between *P* and *P'* in principle are acceptable to both parties. Yet, party *X* prefers agreements as far to the right of *P* as possible (preferably point *P'*), while party *Y*'s welfare increases the higher up the agreement point is (preferably point *P*). In the presence of multiple equilibria, the two parties are in disagreement over which specific cooperative outcome shall be chosen (schematically represented by points *A*, *B*, *C*, and *D*) . Bargaining over this distributional conflict might drag on for a long time, which frustrates the gains from cooperation and binds other resources (e.g. Fearon, 1998). The prospect of significant bargaining costs and even a possible breakdown of negotiations creates a need for an IO. The contracting parties decide to delegate the decision of specifying a Pareto-improving outcome to an impartial third party. The IO suggests one equilibrium (in this case point *C*) that is then accepted as the focal outcome.

[33] "Leaving these smaller issues to be handled by an IO is much more efficient than direct negotiation, since the costs of interstate bargaining loom large compared to potential gains" (Thompson and Snidal, 2005: 13).

[34] Given that the trade agreement cannot be explicit about all cooperative details, the tasks of a trade organization may typically include filling in details of the agreement as the regime develops, interpreting and applying its rules when certain issues are unclear (clarifying what sort of behaviour is permissible), handling unforeseen circumstances, or addressing new issues as they arise.

Distribution conflict in cooperation agreement



Source: Graphical analysis by authors, based on Powell, 1994.

Note that this representation is highly schematic. It only involves two players who are fully informed about the details of their cooperation. The role of the IO as equilibrium setter becomes even more pronounced, if one considers multiple players, negotiations on multiple issue areas, and a highly dynamic environment. Under those circumstances, the number of possible cooperation alternatives explodes. At the same time, growing complexity and high volatility of party preferences result in less certainty – many countries will not be able to detect the Pareto frontier any more. All this leads to more distributive disagreement between parties. Hence, in situations of multiple equilibria and multiple, heterogeneous principals, signatories have an interest in creating an institution, the tasks of which are to safeguard the attainments of the Pareto frontier (i.e. that no party hijacks the process, or that no crucial detail is overlooked), and to suggest those cooperative alternatives that most closely reflect the collective interest. If the process of doing so is perceived as neutral, fair, and legitimate, the proposed outcome will become focal and the welfare-improving equilibrium is enacted. Even if some state "loses out" in one aspect of the contract, it will remain supportive of the cooperation outcome if it expects to gain overall from the resulting outcome.

Centralize operations (regime support)

Another role for IOs is the centralization of collective activities through a concrete and stable organizational structure, and a supportive administrative apparatus (Koremenos et al. 2001, Abbott and Snidal 1998). As was shown in section B.1.(b) above, states delegate powers to the IO with the aim of economizing on transaction costs, and to increase general efficiency. Whenever states pool resources, IOs can more effectively improve the quality and flow of information, provide background research, and technical assistance. Regime support is largely a passive role for an international organization. However, centralization efforts can also "enhance the organization's ability to affect the understandings, environment and interests of states" (Abbott and Snidal 1998: 5).

Monitor and maintain the equilibrium

As was pointed out above (subsection 1.(b)), an important part of IO regime management involves the settling of disputes and the monitoring of parties' trade policies. Those are important tasks in maintaining a stable cooperation equilibrium.

Whenever unforeseen circumstances require a reinterpretation of the contract, whenever gaps occur due to lack of a mutually-accepted bargain, or when textual ambiguities or opportunism provoke a trade dispute between parties, the IO is charged with imposing a structure-induced equilibrium (at least temporarily). As an arbiter and dispute settlement organ, its role is not to restrain state power, but to provide a focal point, which directs the behaviour of parties until the issue is resolved in an intergovernmental forum. In fulfilling this function, the IO is guided by the collective spirit (the object and purpose of the agreement) and bound by its mandate. Its role is to protect weaker states, mitigate the influence of those individual actors that threaten to harm the collective benefit, and to secure compliance with general rules of international law. Monitoring state policies is another important aspect of supervising the equilibrium path. Lacking executive powers, this typically involves information creation and dissemination.

The perception of an IO as neutral is essential to its autonomy (Milgrom et al., 1990; Greif et al., 1994). If an IO is known to be "captured" by one or more parties, its reputation as a reliable and credible source of information and judgement diminishes in the eyes of the other parties.

Regime evolution

An important (albeit controversial) insight from constructivist theory is that through the development of specific competencies and channels of communication, IOs can influence agendas and goals (Cohen et al., 1972, Cyert and March, 1963). As "creators of meaning and of identities" (Olsen, 1997), organizations are said to forge international perception, discourse, norms and values (Finnemore, 1996; Finnemore and Sikkink, 2001). It is important to stress that it is a deliberate choice by countries to commission IOs with the task of shaping and evolving the equilibrium path in a way that is compatible with the collective interest. Regime evolution does not happen exogenously, but is tied to the principal-agent relationship, and the interests of the membership. As stated by Abbott and Snidal (1998: 25) "[t]he creation and development of IOs often represent deliberate decisions by states to change their mutually constituted environment and thus themselves. IOs can affect the interest and values of states in ways that cannot be fully anticipated. Yet it is important to stress that these processes are initiated and shaped by states and constrained by institutional procedures".

Regime evolution usually pursues the objective of deepening cooperation. To that end the IO undertakes efforts to modify the political, normative, and intellectual context of interstate interactions. The channels of influence are usually personal involvement of IO officials (as mediators in negotiations and as prominent members of "epistemic" communities that aim to transmit new ideas), technical assistance, information gathering and creation, and research.[35]

(iii) Issues of control – the balance between autonomy and oversight

Shareholders of companies regularly hand over significant authority to their management. Managers exercise this autonomy under the supervision of the company ownership. The same is true for the case of international organizations (Thompson and Snidal, 2005). As we have seen, states entrust IOs with some autonomy because this allows them to achieve levels of cooperation that might otherwise be unattainable due to distributional conflicts among them.

[35] The legitimacy of the IO as a manager of regime evolution stems from inclusiveness, neutrality, and technical competence.

The question then for signatories to a trade agreement is what level of autonomy should the IO be granted, and how much oversight should there be by individual parties, or by the membership as a whole. States are hesitant to grant too much autonomy to IOs, since this may produce "sovereignty costs" (unwanted policies, lost disputes, or simply a loss of control; cf. Thompson and Snidal, 2005: 16). Yet more individual control means sacrificing collective benefits. Strong individual supervision will produce less gains from IO autonomy – the IO may not be able to achieve the goals for which it was established in the first place. In addition, individual control may provoke hostile reactions from other Members, who will put less trust in an IO that suffers from "agency capture". Stricter collective control,[36] in turn, implies higher sovereignty costs for individual Members due to majoritarian decisions, and to time-consuming decision-making processes (the very "collective action" problem that motivated the creation of the IO in the first place). In short, a country can never concurrently enjoy the benefits of IO autonomy and exercise fully satisfying levels of control. Therefore, a trade agreement is always a delicate balance among short-term and long-term individual, collective and distributional interests.

Does that mean that the problem of "mission creep", i.e. unchecked evolution of the IO into unanticipated and unwanted areas is inevitable (Barnett and Finnemore, 2004)? Probably not. Two important factors keep the autonomy of an IO within reasonable bounds. First, collective control mechanisms and majority interests can address possible runaway problems. Second, the IO's autonomy is naturally constrained by its need to maintain the cooperation equilibrium by making sure that no parties wish to (partially) exit the institution.

Box 6: Is the WTO a public good?

It is sometimes argued that the benefit of having a trade agreement spills over to those countries who could never have afforded to craft and design a detailed trade agreement. In this context the question arises whether trade agreements – and the WTO as the most prominent example of a multilateral trade agreement – provide the international community with public goods.

Public goods are usually defined as those sharing the two characteristics of non-rivalry in consumption and non-excludability.[37] Since the WTO as a treaty applies exclusively to Members (and therefore features excludability), it may be more apt to concentrate the discussion on whether the WTO is a club good of sorts.[38]

Robert Staiger (2004) argues that the creation and maintenance of the WTO has important global public good features, but that its utilization by Member governments need not exhibit the features of a global public good. The idea is that the main collective action problem lies in creating and maintaining the institution as an effective negotiating forum for Member governments. However, the use to which the negotiating forum is put by Members is more likely a private good.[39]

36 Collective control mechanisms are oversight bodies, voting rules, budgetary control, or managerial control (e.g. selection of top bureaucrats).

37 Non-rivalry means that the consumption of a good by one individual does not reduce the amount of the good available for consumption by others. Non-excludability means it is not possible to exclude individuals from consumption of the good. Fresh air is usually cited as an example of a (pure) public good. For reasons of collective action dynamics and market failure, public goods are often provided by society as a whole (e.g. a government).

38 Club goods are defined by non-rivalry in use and excludability (e.g. Aggarwal and Dupont, 1999). Internet access is a prominent example of a club good. To be sure, with a Membership of 150 countries (as of January 11, 2007), the circle of "club members" is bigger than those currently out of it. This is not to say that the WTO does not produce any non-excludable benefits at all. Arguably, through its promotion of global peace, rule of law, or stability and predictability in international trade, the WTO yields some benefits to non-Members.

39 As discussed in Section B, this is so because Members who use the WTO as an escape from a terms-of-trade driven prisoner's dilemma can effectively internalize all the benefits accruing from their negotiations. Two countries negotiating non-discriminatory tariff reductions on a reciprocal basis manage to improve the competitiveness of their respective export sectors, which are therefore best placed to exploit the additional market access offered by their trading partner's market liberalization.

Staiger's arguments highlight two important aspects relevant to the overall discussion of the public good character of trade agreements. First, the author makes clear that he argues within the strict confines of the terms-of-trade theory. Second, Staiger insists on the distinction between the rationale for an agreement (WTO as negotiation/cooperation forum) and the rationale of creating an organization. This captures well the central concerns pursued so far in Section B (reviewing different rationales for trade cooperation), and Section C.1 (giving reasons for the existence of formal trade organizations).

Trade cooperation as a club good?

Staiger's suggestion that the actual trade cooperation is a private good enjoyed by two (or more) large negotiating countries is accurate for the terms-of-trade rationale of trade agreements, which mainly considers reciprocal tariff liberalization. But does the same logic hold in WTO areas that do not feature reciprocal tariff cuts, such as TRIPS and TRIMs? If the WTO is understood as a commitment device, once in existence, every Member of a trade agreement can "peg" its domestic trade policy decisions to the external trade deal at no cost. Economics aside, considering rationales for a trade agreement from the literatures of IR and international law further shows that the benefits of a multilateral trade cooperation agreement may effectively spill over to all signatories (and arguably even beyond the membership), no matter how active they were in the initial negotiations. If motives like bloc-building, promoting peace, or spreading a global liberal trading order are considered to be at the core of the decision to cooperate, then the WTO can hardly be seen as a private good. Also, trade cooperation perceived as a global constitution aiming at instituting a rule-of-law based trading order (as maintained by some legal scholars), also may yield benefits to those small Members that kept a low profile in initial negotiations.

Membership in the Organization as a club good?

Under the umbrella of the WTO, all signatory countries enjoy the same membership rights (including a de facto veto right), and have equal access to the services of the Organization. Legal scholarship has long maintained that WTO rights and obligations (codified in rules)[40] are applied *erga omnes partes,* i.e. to the Member community as a whole (e.g. Pauwelyn 2001). The *erga omnes partes* principle applies to non-discriminatory trade liberalization commitments just as much as to disputes panel recommendations, or to information and transparency requirements – they are owed to the membership as a whole and not bilaterally between large nations.[41] Therefore, it is probably fair to say that all WTO Members benefit from this legal precept. Section C.1 reviewed a large number of roles that an independent trade organization can deliver to its Members. In providing its services (information provision, dispute settlement, trade assistance, negotiation facilities, etc.), the organization does not discriminate among countries and hence represents a common good to every WTO Member.

To conclude, as a negotiating forum as well as a formal trade organization it is probably accurate to regard the WTO as a club good that delivers significant advantages even to those Members that either cannot afford actively to participate in all negotiations, or that have not yet made significant tariff liberalization commitments in the various trade rounds.

40 Subsections 2-5 below will review the most important rules that any trade agreement should feature.

41 For example, as was shown in subsecton.5 above, economically small countries do benefit from an MFN clause, even though they technically cannot change world prices with their behaviour. Other examples are standardized prohibitions of non-tariff barriers (e.g. in the SPS Agreement), or notification and transparency provisions that benefit to the efficiency of the trading system as a whole.

(d) Summary: the role of institutions

This section was concerned with an important topic of treaty design – namely, why contracting parties to trade agreements regularly cede a part of their sovereignty and confer authority and decision-making capacity to an institution? What sets formal trade organizations apart from alternative cooperative arrangements, such as decentralized cooperation, informal contracting and ad-hoc contracts? If we presume that countries predominantly conclude trade agreements to overcome economic and political cross-border externalities then we can safely conclude that that institutions matter for at least four important reasons.[42]

First, institutions prepare the ground for trade cooperation. The discussion of non-economic approaches to institutions showed that formal trade institutions can contribute substantially to establishing the general conditions for trade cooperation. Institutions can foster peaceful relations among countries, can shape the generation of common norms and values, and help countries with heterogeneous preferences achieve a cooperative equilibrium in the first place.

Second, institutions enhance transactional efficiency. The creation of a neutral body administering and overseeing trade relations enhances the efficiency of international trade. It was pointed out that institutions can significantly reduce transaction costs and improve transparency in generating and disseminating information to the membership.

Third, institutions enforce the explicit "rules of the game"**.** Although there is no supranational enforcement agency in international trade, institutions can nevertheless help to lend weight to the agreed-upon rules and procedures of the contract. By keeping an eye on procedures and timelines, by informing previously ignorant parties of treaty infringements, by facilitating trade litigation, by conciliating and arbitrating, and by continuously supervising compliance with the explicit treaty rules, institutions add substantially to the predictability and stability of the international trading order.

2. TRADE LIBERALIZATION

(a) Reciprocal liberalization

As explained in Section B above, international trade cooperation provides a way of escaping from the terms-of-trade prisoner's dilemma and relaxes the political economy constraints faced by policymakers at home. Cooperation allows countries to reduce levels of protection below what they would have chosen individually. The process that produces this cooperative outcome – where countries achieve higher levels of international trade and welfare – is reciprocal liberalization.

Reciprocal liberalization means parties to a trade agreement are required mutually to reduce levels of protection below the prisoner's dilemma (suboptimal) starting point. The nature of these reductions can be defined generally or more precisely. In Mayer (1981), reciprocal liberalization is equivalent to moving to the "efficiency locus"[43]. It is not necessary for the terms of trade at this cooperative outcome to be equal to what prevailed at the prisoner's dilemma point. In Bagwell and Staiger (2002), not only are countries required to be on the efficiency locus, but also reciprocal liberalization between parties to an agreement must leave their terms of trade unchanged. The coordinated reduction of protection by all parties to the negotiation expands the volume of trade, which is welfare enhancing for all. On top of this, the terms of

[42] One important issue left out of the scope of our debate is what roles institutions assume once the overarching tenet of national governments as unitary (or monolithic) actors is relaxed. Some governmental entity (say, the executive) may then grant significant authority to an outsider (the IO) in an attempt to prevent other domestic entities (say, the legislature) from torpedoing or retracting from earlier commitments. In the same vein, the idea of the IO as a unitary actor can be relaxed (Elsig 2007). In general, the use of more intricate principal-agent models featuring multiple domestic principals and multiple institutional agents is a promising field of research on the nature and roles of international organizations (see. e.g. Hawkins et al., 2006; or Checkel, 2007).

[43] These are pareto-efficient outcomes where improvements in one country's welfare will come only at the expense of the welfare of its partner. The locus is characterized by the tangencies of the welfare curves (defined over the policy instruments) of the parties to the negotiations.

trade remaining unchanged means that this trade expansion is not accompanied by world price changes that leave one of the parties less well off. In contrast, a unilateral reduction of tariffs by one of the parties to the negotiation would cause a deterioration in its terms of trade and must hurt it. This helps to explain the apparent mercantilist behaviour of governments during trade negotiations when they resist moves to open their markets but at the same time attempt to pry open the markets of their partners.

If there are only two parties involved in a negotiation, the reduction in tariffs offered by one country is clearly intended to apply to the other party. If there are more than two parties involved in the negotiation, how should the reciprocal liberalization take place? Should a country provide different market access offers to its partners or should it make only one market access offer that is applied to all its partners in a non-discriminatory fashion?[44]

Efficiency requires that reciprocal liberalization in this multi-country setting be non-discriminatory (Bagwell and Staiger, 2002). If a country discriminates among its different partners, by applying different rates of protection, there would be different "world prices" (or terms of trade) applying to each. This creates the possibility of opportunistic gains for subsets of countries from reciprocal liberalization, which would be at the expense of non-participants whose terms of trade deteriorate.

Thus, to escape fully the prisoner's dilemma outcome in a multi-country setting, one needs both reciprocal liberalization and its application in a non-discriminatory fashion. The role of the non-discrimination principle is to ensure that all terms of trade externalities are channelled only through a single world price. The role of reciprocal liberalization is to ensure that the world price (terms of trade) remains unchanged even as mutual tariff reductions increase the volume of trade and welfare.

The political economy approaches to international trade cooperation can also provide support for reciprocal liberalization. Reciprocal liberalization mobilizes a country's exporters to lobby for greater domestic trade liberalization since it is the avenue through which they gain better access to foreign markets. A counterweight to the import-competing sector is thereby created, diminishing the political heft of these domestic producers.

Although the discussion of reciprocal liberalization is often couched in terms of the tariff rate, it is not the only policy instrument that could be used. The theoretical literature (Mayer, 1981; Bagwell and Staiger, 2002) shows that other instruments, e.g. import subsidies, would be required in the cooperative outcome and that export taxes achieve the same effect on trade and resource allocation as a tariff (Lerner, 1936).[45] So the discussion of reciprocal liberalization should be read in the light of a broader set of policy barriers (e.g. quotas, import bans) – more restrictive in some circumstances than tariffs – that countries could mutually liberalize.

44 A more extensive discussion of the MFN or non-discriminatory principle as applied in the GATT/WTO is to be found below.

45 The intuition for why export taxes have the same effect as tariffs (the Lerner symmetry theorem) can be provided in the context of a two-commodity world involving x (an exportable good) and m (an importable good). Resource allocation in such a simplified world depends only on the relative price (Pm/Px) of the importable with respect to the exportable good. A tariff reduces imports and raises the domestic price of the import-competing good. This leads to a re-allocation of resources in the domestic economy from the exportable sector to the import-competing sector. Thus production in the export sector falls while production in the import-competing sector is ramped up. As a consequence, the tariff not only reduces imports; but due to the induced re-allocation of resources, it reduces exports too. The same outcome can be achieved with an export tax. An export tax reduces exports and the domestic price of the exportable good. This leads to a shift of resources from the exportable to the import-competing sector. As the production of the import-competing sector expands, imports are consequently reduced.
An import subsidy increases imports and reduces the domestic price of the import-competing good. This leads to a re-allocation of resources in the domestic economy from the import-competing sector to the exportable sector. Thus production in the import-competing sector falls while production in the exportable sector expands. As a consequence, exports rise. Thus, the import subsidy not only increases imports, but due to the induced re-allocation of resources, it expands exports too. The same outcome can be achieved with an export subsidy. An export subsidy increases exports and the domestic price of the exportable good. This leads to a shift of resources from the import-competing sector to the exportable sector. As the production of the import-competing sector contracts, imports increase.

(i) Reciprocal liberalization in the multilateral setting

Bagwell and Staiger (2002) have defined reciprocal liberalization in the GATT as a set of tariff changes that bring about changes in the volume of each country's imports that are of equal value to the changes in the volume of its exports. It can be shown that this is equivalent to a set of tariff changes that leave the world price (and hence the terms of trade) unchanged.[46]

Barton et al. (2006) also describe reciprocity in the GATT/WTO as equivalent (trade) value from access to markets. They described the conduct of negotiators in the first round of negotiations, which they argue became the norm subsequently, thus:[47]

> "... the Geneva talks began with countries sending product requests to each other for potential concessions. This was followed by the presentation of a list, to each country, of the concessions the other was willing to grant. Countries were expected to balance the value of concessions with a commensurate value of access to their home market".

Although reciprocity is an explicit criterion in GATT Article XXVIII *bis* (Tariff Negotiations) and thus in the negotiations leading to multilateral trade liberalization, there is no precise definition of it, in the GATT or in the GATS, leaving the concept ambiguous. Besides GATT Article XXVIII *bis*, there are many other GATT and WTO provisions that could be considered relevant to liberalization covering all merchandize goods (agricultural and non-agricultural goods) and services (see Box 7). This has led some long-time observers of the GATT/WTO to emphasize the political aspect of reciprocity ('reciprocity is in the eye of the beholder'). Jackson (1997) considers the process of governments appraising reciprocity in market access negotiations as one that involves making a political judgement. Finger (2005) tends to be sceptical of the theoretical definition offered by Bagwell and Staiger. For him, reciprocity in the GATT/WTO involves an outcome that each member considers advantageous by whatever standard the Member chooses to apply. He refers to an early GATT working party report which, in response to a proposal to establish rules for how concessions should be measured, stated that "governments participating in negotiations should retain complete freedom to adopt any method they might feel most appropriate for estimating the value of duty reductions and bindings."[48]

Box 7: Liberalization-related provisions in multilateral agreements

GATT Article XXVIII *bis* provides a mechanism for Members to conduct periodic "... negotiations on a reciprocal and mutually advantageous basis, directed to the substantial reduction of the general level of tariffs and other charges on imports ..." The negotiations may be directed towards the reduction of duties, the binding of duties at existing levels or undertakings that individual duties or the average duties on specified categories of products shall not exceed specified levels.

Two things need to be noted about Article XXVIII *bis.* First, it refers to the binding of duties at specified levels, suggesting that the undertaking to bind tariffs has an intrinsic value to negotiating parties, a point that economic theorizing about GATT focusing on the terms of trade problem has tended to neglect.[49] Second, the Article does not refer to free trade as a goal, only to the "substantial reduction" in tariffs.

46 This requires that there be balanced trade between the parties before they begin mutually reducing tariffs.

47 See Barton et al. (2006), p. 39.

48 See Finger (2005), p. 30.

49 Some recent papers that have tried to explain the difference between bound and applied rates include Bagwell and Staiger (2005b) and Maggi and Rodriguez-Clare (2007).

The provisions on subsidies are found in GATT Article XVI and the Agreement on Subsidies and Countervailing Measures (SCM). GATT Article XI prohibits the use of quantitative restrictions – quotas, import licensing, etc. – to limit trade, prescribing instead the use of import duties, taxes or other charges. It could be argued that Article XI has less to do with liberalization than with efficiency[50] or even transparency. But there are strong reasons for believing that, at least in the first decade or so of the GATT, the elimination of quantitative restrictions was a critical tool of trade liberalization. In the immediate post-war era, the principal obstacles to international trade were not tariffs, but quotas, import prohibitions and foreign exchange controls (see Section D). By forcing governments to give up those measures, the GATT provided an important boost to trade liberalization. The tariff bindings negotiated in the first few rounds of GATT negotiations then prevented governments from undoing this liberalization through tariff increases.

The Agreement on Agriculture (AoA) was intended to initiate a process of reform in trade in agricultural products. The reform process is to consist of progressive reductions in agricultural support and protection. Articles IV, VI and VIII of the AoA involve market access, domestic support and export competition commitments respectively.

Finally, GATS Article XIX asks WTO Members to enter into successive rounds of negotiations "with a view to achieving a progressively higher level of liberalization" of trade in services. As in the case of the GATT, the goal is not free trade, only progressive liberalization.

Reciprocity in the GATT/WTO has also been weakened in the case of developing countries by the principle of special and differential treatment (a fuller discussion of S&D, going beyond the relationship to reciprocal liberalization, is to be found in Section D). There are two aspects to the dilution of reciprocity that S&D has brought about. The first aspect involves providing non-reciprocal market access to developing countries through such arrangements as the Generalized System of Preferences (GSP). The second aspect involves requiring less liberalization from developing countries than from developed countries in multilateral rounds of negotiations.

While this discussion has focused primarily on mutual tariff reductions, it is important to remember that liberalization in the GATT not only means reduction in tariff rates, but the binding of those rates. The contracting parties to the GATT and the WTO membership have attached as much importance to the legal commitment not to raise tariffs beyond a certain level, and the security in market access that this implies, as towards the reduction of duties. What the GATT/WTO has accomplished in terms of liberalization, through security as a result of bindings, and enhanced market access as a result of reduction in protection, are further discussed in Section D of this Report.

(ii) Reciprocal liberalization in regional trade agreements

How is trade liberalization managed in other trade agreements, in particular regional trade agreements? Two questions are particularly germane. How deep is trade liberalization? And to what extent is reciprocal liberalization achieved?

On the whole, liberalization has been much more ambitious in regional trade agreements (Section D contains a discussion of some of the empirical work in this area). In most of these agreements, the objective is to achieve reciprocal free trade in merchandise goods, a goal more ambitious than the "substantial reduction of tariffs and other barriers to trade" expressed in the WTO Agreement. The available empirical evidence suggests that there is substantive elimination of merchandise trade barriers

[50] There exists a tariff rate that would result in the same level of imports as a quantitative restriction which, for example, limits imports only to some level Q. If demand and supply curves shift around, a tariff that on average allows Q imports reduces welfare less than the quantitative restriction.

although sensitive sectors such as agriculture and textiles and clothing are important exceptions. It is less clear how effectively services barriers are being eliminated in regional trade agreements.

The free trade commitment is also decidedly reciprocal. There is a marked absence of "special and differential treatment" in RTAs even though many of them have both developed and developing country members. The elimination of barriers to trade is expected as much from the developing country as from the developed country member. Thus, there is little of the diminution of reciprocity in market access that is found in the multilateral setting.

(b) A more extensive analysis of the trade liberalization in the most favoured nation principle

The MFN principle stipulates that each Member grant the same treatment to like products originating in all other Members that it extends to its most favoured trading partner; in other words, Members are forbidden from discriminating among their trading partners. Thus, if a country improves the benefits that it gives to one trading partner, it has to give the same "best" treatment to imports of like products from all other WTO Members so that they all remain "most-favoured". Given the dominance of the MFN principle in multilateral trade negotiation, it is often referred to as one of the so-called "pillars" of the WTO.

Thus far the logic of trade liberalization has mainly been expounded with reference to only two countries. Extending the bilateral terms-of-trade driven prisoners' dilemma to a multilateral setting complicates the analysis but does not negate the logic of trade liberalization as discussed above – reciprocal tariff reductions facilitate mutual alleviation of the beggar-thy-neighbour effects of governments' trade policies.

However, the rationale underlying the decision by governments to establish a multilateral trade negotiating framework based upon non-discriminatory liberalization does not easily follow from this logic and thus requires explanation. Why have governments committed themselves to extending concessions made to one trading partner to all Members of the WTO? What benefit do they obtain from restricting themselves in this manner?

This subsection provides an introduction to the MFN principle, both historically and theoretically. Moreover, it also provides a discussion of the rationale underlying exceptions to MFN as provided for in the GATT via the potential to form discriminatory regional trade agreements and to give special and differential treatment to developing countries.

(i) MFN before the GATT

The inclusion of clauses relating to non-discriminatory treatment in trade agreements can be traced back to the 12th century, with the first reference to the phrase "most favoured nation" appearing at the end of the 17th century.[51] The emergence of the concept of non-discrimination stemmed from the decline in mercantilism and from a desire to link commercial treaties through time and among states. In the intervening period up until the formation of the GATT, bilateral and plurilateral MFN trade deals were conducted utilizing both the conditional form of MFN, where concessions were granted on the condition of receiving adequate compensation, and the unconditional form, where concessions were granted without reciprocal compensation. The wave of liberalism that swept Europe in the second half of the 19th century engendered widespread use of the unconditional form of MFN. The United States, however, being a relative newcomer to international trade, retained the conditional form at that time. Following the end of the First World War, the United States experienced a considerable increase in demand for its exports from Europe. Therefore, in the 1920s US MFN policy changed to that of unconditional MFN in a bid to entice other countries to do the same with respect to the United States, thus reducing discrimination against US exports. The modern day version of MFN, enshrined in WTO jurisprudence via GATT Article II and GATS Article II, is a direct descendent of the MFN clauses in bilateral agreements between the United States and its trading partners.

[51] See US Committee on Finance (1973*), The Most Favoured Nation*, Executive Branch GATT Study, No. 9.

The MFN principle is also applied in numerous regional trade agreements. Indeed, it is important to distinguish between MFN and "multilateralism", which, as noted by Jackson (1997), are sometimes confused with each other. Multilateralism is an approach to international negotiation that involves the interaction of a large number of nation-states. MFN, instead, is a principal applied within negotiations, regardless of whether those negotiations are conducted multilaterally, plurilaterally or bilaterally.

A number of authors have argued that MFN embodies strictly political benefits. For example, both Jackson (1997) and Pomfret (1997) argue that non-discriminatory behaviour mitigates potential tensions that would otherwise arise were countries to be excluded from trade agreements. Indeed Pomfret (1997) notes that frequent controversies involving the United States and nations excluded from their discriminatory trade agreements was one reason why the United States embraced the notion of unconditional MFN after the First World War. Moreover, Ghosh et al. (2003) posit that initial advocacy of the MFN clause by the Organisation for Economic Cooperation and Development (OECD) countries stemmed from a desire to prevent newly independent developing countries from being drawn into adopting a communist regime. Thus, MFN can be viewed as a strategic tool in international relations.

(ii) The economic rationale for the MFN principle

There is widespread belief among policy makers that there is also a strong economic rationale for the MFN provision. This belief is largely based on the presumption that discrimination is inherently undesirable. In a world where free trade maximizes global welfare, there is, of course, no scope for tariffs at all, discriminatory or not. The efficiency of MFN tariffs thus becomes an issue only when diverging from such a scenario.[52] In such a case, there is no a priori argument to be made for non-discrimination as a feature of tariff schedules. For instance, both the literature on optimal taxation and the industrial organization literature on price discrimination suggest reasons why discrimination may be socially desirable.[53] More generally, it could be argued that it is more obvious that discrimination would increase welfare. A move from a policy of non-discrimination to a policy permitting discrimination removes a constraint on tariff policy, and optimization subject to fewer constraints can only result in a higher optimum.

Viner (1931), however, had already pointed out in the 1930s that even in situations where discriminatory tariffs are desirable, the administration of such discriminatory tariffs is costly because of the need to keep track of product origin. Related rules for the issuance of certificates of origin, direct shipment requirements and other relevant administrative procedures can impose significant costs on both enterprises and governments. Costs tend to be higher for products not produced in one single stage, as proof is needed to show that a product has been sufficiently processed in the partner country in order to receive preferential treatment. With MFN, instead, there is no need to keep track of product origin. By simplifying customs procedures, MFN thus significantly reduces informational as well as administration costs.

Furthermore, Horn and Mavroidis (2001) argue that MFN makes policy makers less prone to capture by producers, as it appears to be the case that more "fine tuned" trade policies give more scope for interest groups to influence tariff setting. Authors such as Grossman and Maggi (1997) and Irwin (2002) argue that commitment to a specific trade policy not only guards against subversion of government policy by politically strong minorities at the expense of politically weak minorities, but it also reduces incentives to engage in wasteful political lobbying.

A strong argument in favour of the MFN principle comes from Bagwell and Staiger (1999a, 2002), who emphasize that it is necessary in order for governments to engage in the mutually beneficial bargaining process described before. Previous sections have established that reciprocity is a key pillar of the GATT as it neutralises the terms-of-trade effects of trade liberalization and thus allows governments to remove tariffs and thereby assuage the domestic distortions that they induce. A crucial element in this approach

[52] See Horn and Mavroidis (2001).

[53] For example, an optimal tariff schedule would involve discriminating among trading partners on the basis of differences in the elasticity of supply of their exports.

is that the beggar-thy-neighbour effects of trade policy travel through world prices alone. Bagwell and Staiger (1999a, 2002) argue that, absent MFN, the trade policies of governments would also influence local prices. Accordingly, they contend that the MFN provision restricts the cross-border effects of trade policy to world prices and thus facilitates reciprocal liberalization. When MFN is violated, the principle of reciprocity is impaired and the efficacy of the WTO diminished. The intuition is that in a discriminatory environment, governments are no longer just concerned with the total amount of imports (i.e. the world price), but also with the relative share of imports coming from each supplying country (i.e. local price abroad) as they enter under a different tariff, implying different tariff revenues. This generates local-price externalities which inhibits the ability of reciprocity to maintain the terms-of-trade. By forcing governments to treat trading partners equally, the MFN principle removes consideration of relative import shares from government decision-making and thereby makes world prices the primary factor of concern. This restores the incentive for governments to fully engage in reciprocal liberalization.

Furthermore, Bagwell and Staiger (2002) have argued that MFN in combination with reciprocity enhances the stability of the multilateral trading system. This argument builds on the possibility for WTO Members to renegotiate their bindings agreed upon in a previous round, as provided for in GATT Article XXVIII. However, the agreement imposes certain limits on what can be achieved through such a renegotiation. Affected parties should be offered compensation for the withdrawal of concessions in the form of an extension of concessions on other goods on an MFN basis by the country seeking the withdrawal, such that the affected parties are fully compensated.[54] Alternatively, if the parties cannot agree on such compensation, affected Members may become entitled to take countermeasures by withdrawing "substantially equivalent" concessions of their own. Theoretical analysis has shown that MFN and this latter type of reciprocity may work in concert to make initial agreements immune to renegotiation. But the MFN principle has rather complex effects on negotiators' strategic behaviour and on the efficiency of negotiated outcomes, as illustrated in the following discussions.

MFN and the bargaining process

Whilst the above logic suggests that MFN is an essential element for facilitating multilateral trade bargaining, it has been suggested that the MFN principle also plays a role in shaping the actual process of bargaining. There are three potentially co-existing effects: the circumvention of the concession-erosion effect; the foot-dragger effect; and, the free-rider effect. Of these three, only the circumvention of concession-erosion effect acts to the benefit of multilateral negotiations. Whilst it is conceivable that the net result of these three effects may be negative, it is important to highlight that the logic in the above paragraphs implies that multilateral trade bargaining requires MFN to exist in the first place.

The logic of concession-erosion has been discussed by a number of authors.[55] Assume that countries A and B agree to liberalize trade via reciprocal tariff concessions. If they are free to discriminate between trading partners then one of them, e.g. country B, may later make another trade deal with a third country C giving that third country even higher concessions. In this case, the initial benefits obtained by country A will be eroded via trade diversion to country C. Foreseeing this, country A would be willing to offer less in the initial negotiation and the scope for trade deals would be duly diminished. MFN tempers the potential for concession diversion in two ways.[56] Firstly, by stipulating non-discriminatory behaviour by country B towards country A, it ensures that the market access bargained for by country A is not diverted entirely to one of its competitors at a later stage. Secondly, if country C is bound by MFN then any concession it offers to country B must be extended to all of country B's competitors. Accordingly, any further trade deal negotiated by country B will simply amount to further reciprocal liberalization. This removes country B's incentive to deal sequentially and thus encourages country B to make an optimal deal in the first place.[57]

54 Bown (2004) provides empirical verification of the extent to which this form of reciprocity occurs in reality.

55 See Ethier (2004), Schwartz and Sykes (1997) and Bagwell and Staiger (2004a).

56 See Ethier (2004) and Bagwell and Staiger (2004a) for models on concession diversion.

57 Bagwell and Staiger (2005b) argue that MFN is not enough to eliminate concession erosion. They show that MFN eliminates concession erosion only in combination with a reciprocity condition and that MFN and reciprocity together also eliminate the free-rider effect.

The "foot-dragging" and "free-rider" effects act to the detriment of trade negotiations in that they provide countries with incentives to hold back from making deals in order to maintain bargaining chips for future negotiations (in the case of the foot-dragging effect) or to capture the gains from unreciprocated concessions granted to them via the MFN trade deals of other countries (in the case of the free-rider effect).

The foot-dragging effect arises when agreements within multilateral negotiations are undertaken sequentially. For example, consider the case where countries A and B are initially in talks about potential reciprocal liberalizations but where country A expects that at a later date it will commence similar talks with country C, a larger country. The MFN clause stipulates that any market access concession extended to an initial negotiating partner is automatically extended to any future negotiating partner, thus country A's concession to B would automatically be extended to country C. In such a context, country A may offer little in the way of initial concessions to B so as to retain a stronger bargaining position for its subsequent negotiation with country C.[58] This inhibits the formation of trade deals at every stage and thereby restricts potential welfare improvements from both an individual country and a global perspective. Jackson (1997) argues that the single undertaking principle that was introduced during the Uruguay Round (and which remains part of the Doha Ministerial Declaration) reduces the incentives for foot-dragging by ensuring that the deals within any specific round must be completed simultaneously and accepted universally. However, Bagwell and Staiger (2004a) note that, in reality, most issues within multilateral talks are negotiated by a subset of countries and that dynamic shifts in levels of economic development and the accession of new Members means that it is routine that a country will engage in negotiations on a product with one country, having previously negotiated on that product with another country. Thus, they conclude that sequential bargaining is prevalent and that the possible damage caused by MFN-induced foot-dragging is significant.

The "free-rider" argument is one that has long been recognised and has received considerable attention in the literature.[59] In essence the logic of this objection to MFN stems from the fact that foot-dragging nations can benefit from unreciprocated concessions when other like-minded nations go ahead with a trade deal despite their reluctance to participate. For example, consider again the case of countries A, B and C. If countries B and C decided to conduct an MFN-based trade deal but country A decided to abstain from the deal, then country A would benefit from the concessions B and C offer to each other via MFN, but would not have to make equivalent concessions itself. MFN would then slow down trade liberalization and countries would be worse off than if they chose to liberalize without MFN.

Some economists have presented theoretical arguments scaling down the possible negative effects of MFN-induced free-riding effects. It has, for instance, been argued that MFN-induced free-riding serves to smooth the effects of bargaining power asymmetries between negotiating parties and leads to a more equitable distribution of gains from trade liberalization.[60] Others cast doubt on the relevance of MFN-induced free-riding in practice. Ludema (1991), for instance, presents a model, where countries can make agreements conditional on similar agreements being made by other parties. This feature accords, according to the author, well with the ratification procedures governments engage in before accepting trade deals. Under these conditions, the decision of one country to free-ride would trigger a temporary breakdown in negotiations. With sufficiently high discount factors, countries elect not to free-ride in equilibrium because the postponement of liberalization acts as an effective deterrent.

The existing empirical literature, however, indicates that free-riding may indeed have had the effect of slowing down trade liberalization in the past. For example, Finger (1979) analysed tariff concessions during the first six rounds of the GATT and noted that, in order to circumvent MFN, countries negotiated on very narrow product descriptions such that concessions were generally extended to negotiating partners and not to potentially free-riding third parties. A study of US tariffs prior to the Tokyo Trade

58 See the discussion in Bagwell and Staiger (2004a).

59 Viner (1924, 1931, 1936) was a key author in the initial recognition of the "free-rider" problem; Johnson (1965) provided the first formal model; see also Baldwin and Murray (1977) and Baldwin (1987) for further discussions.

60 See Caplin and Krishna (1988, Section 6) and Ludema (1991).

Round by Lavergne (1983) found that tariffs were consistently higher with respect to goods produced predominantly by developing countries. After controlling for political factors, Lavergne (1983) interpreted this as evidence that the United States was engaging in less liberalization in order to avoid extending MFN concessions to free-riders. This finding has been corroborated recently by Ludema and Mayda (2005) who find that US tariffs are lower with respect to goods in which they, and their negotiating partner, have a larger market share, i.e. in which there are less potential free-riders. They argue that this is evidence of a significant free-rider effect in WTO negotiations.

If the free-rider problem becomes acute, there are various options for changing the structure of negotiations to try to reduce it. One possibility is for nations to abandon the product-by-product negotiations over concessions and instead agree that every nation will afford tariff cuts in accordance with a mutually agreed formula.[61] The difficulty here is that across-the-board cuts fail to exploit the joint political gains from a more subtle and tailored set of concessions. However, Hoda (2001) notes that in the past countries deviated significantly from the formula approach on an item-by-item basis, and that some countries ignored the formula completely. The more that countries deviate significantly from the formula with their item-by-item exceptions list, the more the free-rider problem re-emerges.

The logic presented here suggests that, whilst MFN is potentially an essential element for the formation of multilateral trade negotiations, the net result of its subsequent effect on the bargaining process is ambiguous. However, a number of authors have ventured separate arguments in favour of MFN. Such arguments generally focus on the efficiency gains resulting from non-discriminatory trade liberalization.

Non-bargaining based benefits of MFN

Theoretical examinations of the efficiency effects of the MFN principle are typically based on models that assume global markets are not perfectly competitive. Assume a world with three countries where one country imports a good from the two other countries. In each exporting country one single firm produces and exports the relevant good. These firms therefore have market power and take advantage of it by extracting rents from consumers in the importing country. The importing country government may then decide to take some of those rents back through tariffs.

An incentive for discrimination will now arise if one firm is more productive than the other. The most productive firm will have higher rents and the importing country government will want to impose higher tariffs on that firm as this approach generates higher tariff revenues. With respect to the allocation of world production, this leads to inefficiencies, because the most efficient firm is "punished" and production is shifted to its less efficient counterpart in the other exporting country.[62]

In such a situation the MFN rule would make it impossible for the importing country to discriminate among producers with different levels of efficiency and the world would end up with an efficient production structure. However, not every country would be better off under the MFN principle. In fact, only the country hosting the most efficient exporter gains. The other exporting country looses, as it would have preferred preferential treatment by the importing country. The importing country also looses, as it would have preferred to extract higher rents from the most efficient exporter.

This set-up, thus, provides one possible explanation, why countries would want to form preferential or regional trade agreements, a concept that is developed further below. It has therefore been argued

[61] A formula approach was used in the Tokyo and Kennedy Rounds and it appears to be the favoured approach in the ongoing non-agricultural market access negotiations in the context of the Doha Round.

[62] See Hwang and Mai (1991). A model similar to the one by Hwang and Mai (1991) is constructed by Gatsios (1991), who considers the same production structure but incorporates the possibility that the governments of the exporting countries can subsidise exports. The results are virtually identical with several policy active countries, as the government of the importing country will endeavour to extract the greatest rents from the lowest cost producers by levying a higher tariff on imports from the relevant country. Saggi (2004) extends the analysis by considering a more complicated production and market structure in which trade is intra-industry and the global market is oligopolistic in nature.

that in order for governments to agree to include an MFN rule in the framework used for multilateral trade liberalization, the framework should allow for exceptions or be accompanied by some transfer mechanism compensating those who lose out from such a rule. In particular, the above model has been interpreted as representing a scenario involving an industrialized country importer, an industrialized country exporter and a less efficient least developed country exporter. MFN is thus most desirable from the efficient industrialized-country perspective in this context, as it would experience a relative decrease in the tariffs levied on its exports. The MFN principle is not beneficial for developing country exporters and the rationale developed above can therefore be seen as providing some justification for non-reciprocal concessions made to developing countries (in this context by the industrialized country importer). The same logic can also be applied to justify side-payments, such as aid-for-trade, in order for developing countries to accept MFN more readily.[63]

Yet, simple extensions of the set-up described above generate different outcomes and, in particular, predict that the MFN principle makes everybody better off. By adding a preceding stage to the set-up, it can be shown that the MFN principle can help to solve a time inconsistency problem. Imagine a situation where exporting firms choose the level of cost reducing investment before trading partners chose their tariffs. Firms are aware of the fact that any competitive advantage obtained through additional investments would ex post be taxed away by importing countries. It can be shown that as a result companies invest less in cost reducing investments than they would do if they had a guarantee that all companies are taxed equally, independent of their level of productivity. In such a situation MFN would constrain importing countries' ability to tax investments ex post and is also welfare improving for importing countries as they will take advantage of cost reductions and resulting reductions in import prices.[64]

In more complicated economic models involving three countries, the MFN provision can be seen as an avenue of escape from a discriminatory-tariff-driven prisoners' dilemma. Out of three individual players it is rational to discriminate between two trading partners, but where, as a consequence of the resulting strategic interactions, each of the three players ends up being worse off than without discrimination. If, for instance, in country A consumers have a stronger preference for goods from country B than from country C, it would make sense for the government of country A to levy a higher tariff on country B imports than on country C imports if it pursues the objective of maximizing tariff revenues. But such a policy would not be good for consumers and would end up making each country worse off. The MFN principle would ensure a better global outcome, because it would impede the government's ability to extract rents from those consumers who have a high valuation for imported products.[65]

Moreover, MFN can add credibility to the domestic commitments of governments. The political-economy literature regarding the formation of Preferential Trade Agreements (PTAs) has posited that, absent MFN, special-interest lobbies may be able to exert sufficient pressure on their governments to influence them to create a PTA that is beneficial for the lobbies but detrimental to national welfare.[66] Whilst the government would ideally like to refuse to participate in such a PTA, it cannot ignore the votes it would lose as a result of upsetting these lobbies. Adherence to the MFN clause makes the formation of PTAs under these circumstances much more difficult. Accordingly, the government can credibly refuse to concede to the demands of any lobby group on the issue of PTA formation. As a result, MFN allows governments to pursue policies of national welfare maximization rather than being controlled by special-interest groups.

63 See Gatsios (1991).

64 See Choi (1995). See To (1999) for another time inconsistency model, where the source of the inconsistency comes from taxation of domestic consumers in future periods.

65 See Caplin and Krishna (1988, section 3).

66 See Grossman and Helpman (1995), Levy (1997) and Krishna (1998).

(c) Exceptions to the most-favoured-nation principle

Despite the central importance of the MFN principle in the GATT/WTO, it is not without exceptions. In the following part of the Report, two key exceptions will be discussed: the exception given to RTAs and the exception given to developing countries in the form of special and differential (S&D) treatment. In keeping with the conceptual nature of Section C, the focus will be on explaining the reasons behind the exceptions and also presenting the arguments against the exception. A more historical account of how the regionalism and S&D exceptions have fared in the multilateral trading system is given in Section D of this Report.

(i) Regional trade agreements as an exception to MFN

A central exception to the MFN principle in the GATT/WTO is that allowed for customs unions and free trade areas. The exception, under GATT Article XXIV, was allowed from the very beginning of the GATT (see Section D for a historical overview of the article). It is not the only legal instrument used for granting exceptions. The Enabling Clause and GATS Article V also provide for exceptions for MFN for customs unions and free trade areas.

Why does the GATT give this exception to regional trade agreements? There are two arguments that could be made for the exception. The first is that regional trade agreements could contribute to world trade growth.[67] A second argument is that by allowing regional trade liberalization, these preferential arrangements serve as building blocs to further liberalization at the multilateral level. To what extent can these arguments be substantiated by economic theory?

Welfare effects of trade creation and trade diversion

First, it is the welfare effect of RTAs rather than the expansion of world trade that is the right metric to apply in assessing the impact of RTA formation. The reduction in intra-regional trade barriers will stimulate intra-regional trade so trade among the members is bound to increase (trade creation). To the extent that this expanded trade substitutes imports for higher cost domestic products, economic efficiency is increased. But part of the intra-regional trade expansion may be at the expense of trade from cheaper sources outside of the RTA (trade diversion). Box 8 discusses these concepts in greater detail. A country can lose from paying a higher price, in terms of exports, for the goods now being obtained from the RTA partner. Thus, the criterion of world trade expansion may not even be the right criterion to apply to RTAs, because not all of the trade expansion that occurs between RTA partners is necessarily desirable. If the additional trade among the partners is a result of trade diversion, a country can suffer a welfare loss. Whether a country gains or loses from entering into an RTA will depend on the balance between the trade creating and trade diverting effects of the RTA. It then becomes an empirical question whether the welfare gains outweigh the losses.

Box 8: Trade creation and trade diversion

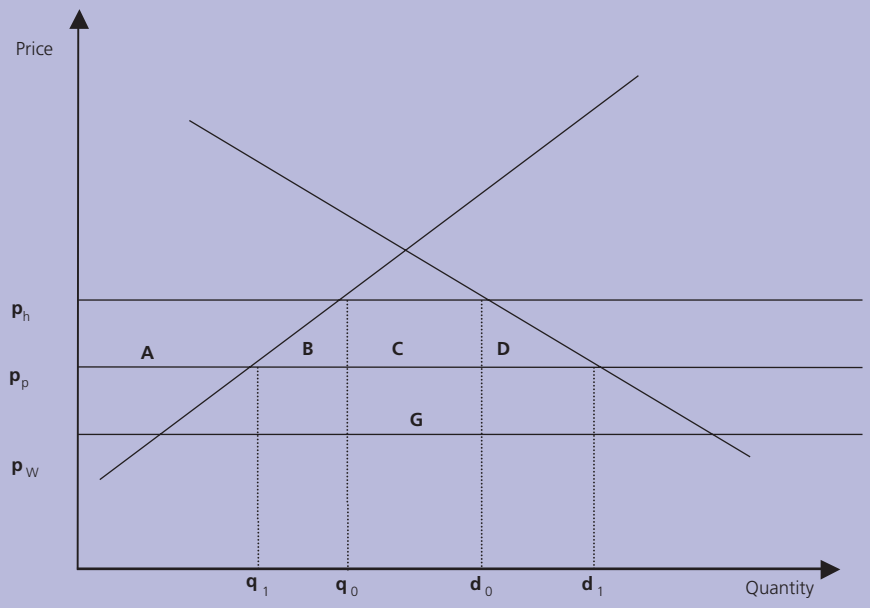
Viner (1950) introduced the concepts of "trade creation" and "trade diversion" in the economic analysis of preferential trade arrangements. They have since become the standard way of analysing the static effects of preferential arrangements. There is however a difference in the way that Viner originally defined these concepts and how "trade creation" and "trade diversion" are presently understood. Viner focused solely on the production effects of customs union. He defined trade creation as the displacement of domestic production by imports from other customs union members, implying that this was economically desirable since production shifts from costly domestic producers to lower cost customs union partners. Trade diversion was the shift in the source of imports from a cheaper non-member to a higher-cost custom union member, which for Viner was undesirable because production shifted from low-cost to higher-cost countries.

[67] In fact, the preamble to the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 states that this exception to MFN reflects a recognition by WTO Members of "the contribution to the expansion of world trade that may be made by closer integration between the economies of the parties to such agreements".

Starting with Lipsey (1957), it was understood that a welfare analysis needed to take the consumption effects of customs union into account. This implied that what Viner would consider a purely trade diverting custom union might still increase welfare, once the impact on consumer surplus by the increased trade is taken into account. Johnson's (1960) partial equilibrium analysis of the effects of a customs union probably represents the closest to the contemporary understanding of these concepts. The partial equilibrium analysis of these concepts can be illustrated below:

Consider a three-country model, where the home country (H) is assumed to be small compared to the partner (P) and the rest of the world (W). It faces an infinitely elastic supply at prices p_p and p_w; that is, at these prices country H can import whatever quantity it demands, but it cannot affect the price. Before forming a free trade agreement (FTA), H is assumed to have a non-discriminatory ad valorem tariff τ on imports. Assume W is the least-cost source of foreign supply, before the regional trade agreement. Then, H will import d_0-q_0 at the price $p_h=p_w(1+\tau)$.

Suppose now that country H and P form a FTA. Country H will now import from P, since p_p is less than p_h (the price it would have to pay for imports from W, since tariffs from the rest of the world did not change). Consumers will now pay p_p and imports will rise to d_1-q_1. As a result of the FTA, overall imports increase by q_0-q_1 plus d_1-d_0 and domestic prices fall. Consumers gain as they can consume a higher quantity for a lower price (the area A+B+C+D represents this gain). Producers lose (area A) and the government loses tariff revenue (area C+G). The area B + D represents the welfare increase from the trade creation effect of the FTA. The area G represents the welfare loss from the trade diverting effect of the FTA. Note that another way of looking at area G is that it represents the additional cost of importing d_0-q_0 from the higher-priced (p_p) partner instead of the cheaper (p_w) world market. The overall welfare effects of an FTA will depend on the difference between the increased welfare from trade creation (areas B + D) and the decrease in welfare from trade diversion (area G). In this example, the FTA increases overall trade but the welfare effect is ambiguous (it may have gone down, gone up or remained the same).



There is a tendency to overestimate the trade creation effects of a PTA. In the case of free trade agreements, for example, where external tariffs may differ, rules of origin are often erected to prevent imports from third countries from being routed through the RTA member with the lowest external tariff. Only goods meeting a given content requirement are eligible to receive preferential tariff treatment. This origin requirement increases the cost for producers in a country which is a member of the RTA to avail themselves of the preferential tariffs. Beyond the fact that they limit the possible trade creation

effect of the RTA, they create economy-wide distortions by leading producers away from the least-cost option. The availability of the tariff preferences give an incentive to producers to use inputs produced in countries who are members of the preferential trade arrangement instead of those outside the bloc. Krueger (1997) and Krishna and Kruger (1995) have called attention to the possible use of rules of origin as a means of protection. Even as tariffs among trade partners in a RTA are reduced, the content requirement could be so configured so that an industry actually receives greater effective protection than before the RTA was established!

What factors are likely to affect the strength of the trade creation and trade diversion effects? All things being held constant, the lower the initial level of MFN tariffs of the countries entering into the RTA, the smaller are the risks of a welfare loss from trade diversion. It has also been suggested that a free trade agreement is more likely to be welfare enhancing the higher is the proportion of trade among the members and the lower the proportion with the outside world (Lipsey, 1960). This has led to the hypothesis of "natural trading partners", the idea that there are certain countries, which because of geographical contiguity or low transport costs are bound to conduct a disproportionate amount of trade with one another so that a preferential trade agreement among them is likely to be welfare increasing (Wonnacott and Lutz, 1989). Krugman (1991) has argued that while the theoretical argument against RTAs may be strong, in practice the welfare loss will be small if the members of the RTAs are natural trading partners. In similar fashion, Summers (1991) assigned crucial importance to whether the members of the trading blocs that form are natural trading partners or not. However, in perhaps the only empirical test to be conducted on the hypothesis so far, Krishna (2003) is unable to find support for the natural trading partner hypothesis in the case of the United States and the FTAs where it is a member.

Beyond the members of the trade bloc, RTA formation will come at the expense of non-RTA members who lose out from trade diversion and from the deterioration in their terms of trade. The expansion of intra-RTA trade may lead to such a decline in demand for the exports of non-members that the prices of those export goods decline in world markets. Some evidence of this effect on excluded countries is given in Chang and Winters (2001). Now there are steps that countries entering into a regional trade agreement can take to ensure that non-members do not lose out. In the specific case of customs unions, where members adopt a common external tariff, it is possible to leave the welfare of non-members no worse off than before if the external tariffs are chosen to leave the volume of trade between the non-members and the customs union members unchanged (Kemp-Wan theorem, 1976; 1986). See Box 9 below for an explanation of the Kemp-Wan theorem. But this is just a "possibility" result; it demonstrates the existence of an external tariff that would leave non-members of the customs union as well off as before. But it does not guarantee that members of the customs union will actually pursue this course of action.

Box 9: Explaining the Kemp-Wan Theorem

The Kemp-Wan theorem (1976, 1986) provides a set of sufficient conditions so that the establishment of a preferential trade agreement increases the welfare of the members without reducing the welfare of non-members. The Kemp-Wan theorem was derived in the context of a customs union, which has a common external tariff. The focus in this discussion is on the second part of the theorem, providing some intuition of how it is possible for non-members to be shielded from the adverse effects of the establishment of a custom union.

The logic behind the theorem is simple. The rest of the world is not adversely affected by the establishment of a custom union if there is no resulting change in the volume of its trade (and, hence, also the terms of trade) with the customs union.

Consider the pattern of trade prevailing before the establishment of the custom union. For each product, aggregate the members' trade with the rest of the world. In some products, the members would be net exporters; in other products, they would be net importers. The removal of tariffs

among the members of the customs union will establish a new economic equilibrium – a new set of internal prices (denoted by the vector p^) and quantities (production and consumption). If the authorities take no further action, this new equilibrium is likely to lead to an expansion of intra-custom union trade that would be at the expense of non-members. But the common external tariff can be adjusted so that for each product the custom union's trade with the rest of the world will remain unchanged.

How are we sure that such adjustments can always be made to the common external tariff? This is the contribution of the theorem. Assume that the pre-union levels of these net exports and net imports are part of the initial endowments of the custom union. Then for purposes of the analysis, one can consider this customs union, with its initial endowments, as a single closed economy. It is then possible to appeal to the Arrow-Debreu (1954) conditions which guarantees the existence of a set of prices (denoted by the vector p*) that will be the general equilibrium of this closed economy, i.e., where for each market, supplies will exactly match demands. Given how the initial endowments of this economy have been constructed, this set of prices will be consistent with the pattern of trade that prevailed before the creation of the customs union. Since this general equilibrium of the closed economy always exists, so must the common external tariff that preserves the customs union's trade with the rest of the world. This common external tariff would be derived from taking the difference between the actual internal prices that prevail after the customs union is established and the general equilibrium prices of the hypothetical closed economy described above. Thus, if for some product j, p^(j) is greater than p*(j) , the common external tariff on that product must be lowered.

Beyond these static welfare considerations, the economic literature has also considered the dynamic interaction between regionalism and multilateralism. One strand of thought suggests that preferential trade liberalization ultimately builds support for liberalization at the multilateral level (building bloc view). But, another stand of the literature, takes the opposing view that regionalism is detrimental to multilateralism (the stumbling bloc view). These ideas and the empirical evidence for each view is discussed in Section D of this Report.

Some conclusions

One of the chief exceptions to MFN in the GATT and WTO is that given to customs unions and free trade areas. This permissiveness partly accounts for the large number of RTAs that have been established since the middle of the 20th century. There appears to be two arguments for this exception. One is that, by allowing deeper liberalization among its members, RTAs promote the expansion of international trade. Second, this liberalization among RTA partners will spur greater liberalization at the multilateral level. On both counts, economic theory tends to be ambivalent. Changes in welfare rather than trade expansion should be the appropriate metric. International trade expansion from preferential trade agreements does not guarantee an increase in the RTA members' welfare and is likely to adversely affect the welfare of non-members. While arguments could be assembled to demonstrate that the members of preferential trade agreements are likely to be beneficiaries, similar arguments could be made to suggest that PTAs will impose welfare losses on non-members because of the trade diversion and terms-of-trade effects. The idea that preferential trade liberalization ultimately builds support for liberalization at the multilateral level will be examined in greater detail in Section D of this report. At this point, it suffices to say that negotiating regional trade agreements absorbs a lot of resources that could be devoted to multilateral discussions. The harmonization of rules and policies, which sometimes accompany regional integration, may lock-in members to the agreement. And once RTA members establish preferential footholds in their partners' markets, very strong incentives are thereby created to try and maintain that. Multilateral liberalization could be seen as a threat to that privileged access.

(ii) The case for special and differential treatment (S&D)

S&D may be portrayed as an exception to the MFN principle in the sense that a sub-set of parties is allowed to provide more favourable treatment to (some or all of) the remaining parties than that which they accord to each other. However, most S&D provisions currently available under the WTO would not be characterized as carrying MFN implications, since developing Members are granted rights that are not available to developed countries by the membership as a whole (who would, hence, all violate the MFN clause). Developing countries then usually may not implement the authorized measures (such as trade restrictions for balance-of-payments purposes or export subsidization) in a way that discriminates among trading partners, i.e. are not authorized to exert their special rights in a way that would have different implications for different trading partners. However, specific forms of S&D may require Members (often on a best endeavour basis) to provide more favourable treatment to developing countries than to the remainder of the WTO membership and, hence, imply departures from MFN. The most prominent examples are non-reciprocal references under GSP schemes. But calls for targeted technical assistance to individual developing countries or other rules that allow Members to treat developing countries more favourably, such as the lesser duty rule in antidumping proceedings or longer time-frames / simplified procedures when enacting trade restrictions for TBT or SPS purposes, could also be seen as exceptions from MFN.

Two questions arise in trying to explain the rationale and existence of S&D in trade agreements. First, why would other countries have an incentive to agree to more lenient obligations for a sub-set of parties? Second, on what grounds can developing countries claim to be systematically different from advanced economies, and to what extent do temporary exemptions from the general rules (otherwise considered economically beneficial) constitute an appropriate response?

Why do parties agree to S&D in trade agreements?

Not much theoretical literature exists on asymmetric obligations in international trade agreements.[68] Bagwell and Staiger (1996 and 2002) have justified non-reciprocity as a form of S&D in an agreement between large and small countries, in order to prevent terms-of-trade losses for the latter. As discussed above in Sections B.2, B.5 and C.2.(b), according to theories of trade agreements based on terms-of-trade externalities, the MFN political optimum is internationally efficient. This implies that, in order to achieve the global optimum, large countries must make market access concessions on an MFN basis, i.e. extend MFN to small countries as well, in order to avoid a deviation of trade from the latter.[69] Also, small countries should not be asked to make market access concessions on an MFN basis (and, thus, receive S&D), since small countries are already (unilaterally) making trade policy choices that, while potentially very trade-restrictive, are nevertheless efficient from an international perspective, since their choices cannot possibly be motivated by international cost-shifting (Staiger, 2006).[70] The authors raise the question when a country can be considered small; once a country acquires some market power for a product to influence relative prices, it may be considered "large" (or "intermediate") and may be called upon to reciprocate market access concessions.[71]

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68 The underlying problem is that most theories are silent on why large countries would have an incentive to negotiate with small countries in the first place.

69 To recall, MFN treatment is necessary in an agreement between large countries in order to avoid an opportunistic erosion of concessions on a bilateral basis. Large countries should be indifferent as to whether or not to bring small countries on board (and extend MFN to them), since the latter are not in a position to impose terms-of-trade externalities. However, the point here is that, from a global efficiency point of view, they should do so.

70 In other words, positive tariffs in a small country represent a domestic political optimum (or else tariffs would be zero) and already reflect the true costs of its policy choices. By contrast, a large country can shift some of the costs of its policies onto other countries through manipulation of its terms-of-trade.

71 More precisely, even apparently small countries have some power over their terms-of-trade, provided that the industry is monopolistically competitive. Also, since transportation costs encourage trade between proximate countries, even seemingly small countries may be able to pass on some of the incidence of an import tariff to exporters in its trading partner. See Bagwell and Staiger (2002).

Political economy approaches, notably in regard to time-inconsistency problems,[72] offer an alternative explanation. As explained in Section B.5, commitments in the context of international trade agreements can help (self-interested) governments to resist demands for protection by domestic interest groups (Staiger and Tabellini, 1987; Matsuyama, 1990; Tornell, 1991; Maggi and Rodriguez-Clare, 1998). Conconi and Perroni (2005) model a time-inconsistency problem in a small(er) developing country as being related to pressure from import-competing industries.[73] The government engages in a trade agreement with a large developed country to solve its commitment problem.[74] At the same time, the smaller country gives a credible signal to put in place high tariffs in the absence of cooperation and therefore manages to engage a large partner that would otherwise have no interest in an agreement. The authors show that it is beneficial for both partners to agree on temporary S&D for the developing country to speed up the transition process towards mutually low tariffs, which are beneficial for both compared to non-cooperation.[75] As suggested in Section B.4, commitment theory may provide a better explanation for bilateral North-South agreements than for multilateral liberalization. The question also remains whether the underlying domestic political economy concerns are not equally pertinent in the developed world.

Finally, contract theory allows for the fact that obligations by trading partners are not necessarily symmetric, reciprocal and simultaneous. Trading partners may differ in their flexibility to make commitments since their probability distribution of future events leading to contract incompleteness may not be the same. Horn et al. (2006) find that, while core disciplines on border measures, such as tariffs, should apply to all trading partners and be rather rigid, discretion (over domestic instruments) is relatively more attractive in a trade agreement; (i) when countries have less policy instruments at their disposal to manipulate the terms-of-trade or when these instruments are less effective; and (ii) when the importing country has less monopoly power in trade. These conditions are more likely to be met by smaller developing countries than by larger developed countries.[76] The authors conclude that S&D might be warranted for smaller developing countries when it comes to contracting over internal measures (such as subsidies).

All three approaches provide a trade-related rationale why developed countries may be willing to accommodate S&D demands within a trade agreement. Of course, they may do so for other reasons as well, such as security concerns or development motives that may either be altruistic or otherwise in their own interest (e.g. an attempt to contain migratory pressures). In any event, for large industrialized countries, the benefits foregone (e.g. in terms of increased market access) are likely to be of little economic importance, while the benefits of increased flexibility may matter for a smaller/weaker country.

How are developing countries different?

The attributes of "smallness", "domestic commitment problems" or "increased uncertainty" used to describe developing countries in the above models are sufficiently unspecific to make the case that

[72] Possibly, a model yielding similar results could be constructed using the assumption of international political economy externalities and the bounded rationality of exporters. The large country would then have an interest to provide temporary S&D to foster political demands by exporters in the smaller country to liberalize.

[73] More precisely, investment decisions in the import-competing sector are based on expected tariffs; *ex post*, investors exert pressure for protection so as to maximize the quasi-rents generated by unanticipated deviations of actual tariffs from expected tariffs. With policy commitment, tariffs are fully anticipated and quasi-rents disappear.

[74] Besides being smaller, it is assumed that the developing country has less dependable political institutions. Its policymakers cannot credibly pre-commit to certain trade policy choices, whereas policymakers in the large country can do so.

[75] In the transition period, the large country accepts a lower surplus than what it could otherwise extract from the small country in order to secure a long-run surplus gain. Conversely, the small country knows that, after temporarily receiving S&D to solve its institutional problems, it might have to accept reduced gains when its privileges are phased out. In the model, the transition to the long-run cooperative equilibrium cannot take place in a single step, since capacity in the smaller country's import-competing sector depreciates slowly and the industry lobbies for the quasi-rents that can be earned in the meantime.

[76] Large countries have a rich array of alternative domestic measures which they can use to manipulate their terms-of-trade if tariffs are constrained through an international trade agreement. Moreover, when a country is large in world markets, it faces foreign export supply that is far from perfectly elastic. In this case, the incentive to distort terms-of-trade through domestic instruments is higher.

developing countries are systematically different and require exceptional treatment. In practice, aspects of these broad characteristics can be found in a range of more concrete arguments that are commonly made regarding the special situation of developing countries.

First, certain developing countries produce a limited number of products. In order to increase their production base, they would need to diversify into non-traditional sectors. However, such countries may suffer from markets imperfections that are not present in a similar fashion in the developed world. Notably, new industries are associated with learning-by-doing costs.[77] Therefore, pioneers incur higher costs of production for an initial time period than established (foreign) producers (infant industry argument) (Melitz, 2005).[78] Realizing the potential for future gains, venture capitalists should be interested to invest in these new activities despite losses in the learning phase. However, the developing country concerned usually faces two problems. First, capital markets may also be characterized by imperfections, such as a lack of transparency and imperfect competition. Consequently, capital is allocated inefficiently and business opportunities in new sectors are not realized. Second, new entrepreneurs cannot appropriate all the productivity gains in the presence of knowledge spillovers.[79] Information asymmetries and externalities of this sort justify government intervention. Finally, the argument goes, in the presence of market failures, countries may wish to pursue second- (or n-) best policies, such as trade restrictions, assuming that an optimal intervention (establishing equity markets or providing production subsidies to compensate pioneers) may not be possible (Grossman, 1990).

Second, developing countries are sometimes confronted with limited market outlets due to a small domestic market size or due to high trade barriers in other markets. In order to improve productivity, new industries in developing countries eventually need to be exposed to competition. In the presence of scale economies, local markets cannot sustain a large number of producers. In addition, import substitution policies put in place in developing countries to protect new industries introduce serious distortions in the economy, including a bias against exports and, hence, exposure to foreign competition (Puga and Venables, 1998). As a means to overcome domestic market limitations while cushioning fledgling industries in developing countries against the full impact of global competition, trade preferences have gained in currency as a strategic complement to import substitution policies. Preferential access is expected to help developing country exports to gain a foothold in foreign markets and to ultimately become competitive under MFN conditions (Langhammer and Sapir, 1987; UNCTAD, 1999).

Third, developing countries are resource-constrained. This has at least three major consequences: (i) developing countries find it harder to adjust to the impact of trade liberalization. They lack the transfer mechanisms to compensate the losers. The costs of structural adjustment are borne by companies who need to invest in new technologies to remain competitive or go out of business and by workers who lose their job and run down their savings while looking for new employment opportunities or undergoing retraining (Falvey et al. 2006). In developing countries, households living at the subsistence level can ill-afford an extended period of unemployment (Matusz and Tarr, 1999). In response, the government may need to establish social safety nets, improve education and revisit its regulatory framework, e.g. in regard to labour laws and wage-setting (Andersson et al., 2005). (ii) Developing countries also face supply-side constraints which may prevent their industries from taking advantage of new trading opportunities, for instance due to inadequate transport infrastructure (Limão and Venables, 2001). They also lack the enabling environment, notably a sound macroeconomic framework, as a complement to trade reform (WTO, 2004). And (iii), the costs of implementation of certain trade obligations are associated with

[77] Learning-by-exporting, whereby pioneer exporters should be compensated for the exploration of foreign markets, is a special case that has been made to justify export subsidization. For a critical analysis see Greenaway and Kneller (2004).

[78] The author also discusses a number of industry characteristics that should be considered in the decision to afford protection, and compares the effectiveness of different instruments, such as subsidies, tariffs and quotas.

[79] More recent variants of the infant industry argument stress the externalities involved in learning what one is good at producing. Entrepreneurs face the costs of discovery, but successful investment opportunities can then easily be imitated by others. The government, it is argued, therefore needs to encourage entrepreneurship and innovation, which otherwise is underprovided (Hausman and Rodrik, 2003).

administrative and infrastructure implications that may strain developing country capacities (Finger and Schuler, 1995). Maskus (2000) notes that sophisticated intellectual property regimes, for instance, may not correspond to the current development priorities of a majority of developing countries but compete for scarce resources without yielding immediate benefits. For all of these reasons, it is argued that developing countries may need to remain exempted, at least temporarily, from implementing certain provisions. They also require technical and financial assistance as well as longer time periods to manage the transition.

To summarize, the economic literature provides possible rationales for S&D for developing countries within trade agreements. However, it is not straightforward to translate these insights into concrete recommendations for trade policy-makers. The identification of countries that should benefit from S&D, of the appropriate policies that should be authorized as exceptions from the general rules and of the conditions attached to their use poses formidable practical challenges. Section D.4 will further discuss how special developing country concerns have been reflected in the multilateral trading system over time and how the remaining challenges could be addressed.

3. SECURING THE GAINS FROM LIBERALIZATION

Trade cooperation focuses on the design of rules that legally prohibit or discipline a defined set of trade barriers. However, there are always a rather large number of possible non-trade or not explicitly trade-based policies that individual member states can implement, which will undermine the value of the negotiated market access concessions to their trading partners.[80]

Economists have shown that in the absence of appropriate legal provisions governments may indeed be tempted to use internal measures to circumvent negotiated market access and that this may trigger "races to the bottom" in domestic policies and reduce the value of negotiation outcomes. Trade agreements, therefore, often make use of additional legal provisions to protect agreed tariff reductions from being undermined by non-tariff trade barriers or other governmental measures.[81]

(a) Internal measures and the effectiveness of trade agreements

(i) Internal measures can undermine negotiated tariff reductions

Negotiated tariff bindings are effective only if they imply secure market access commitments, in the sense that members cannot undermine their commitments using other internal measures. But a large number of not directly trade-related internal measures can have effects that are very similar to tariffs and the use of such policies can therefore offset tariff concessions. Assume a country binds itself to not increase tariffs on steel beyond 15 per cent *ad valorem*.[82] What would happen, if by legislation the country turns the steel industry into a domestic monopoly? Or if it sets a regulatory standard that foreign competitors in the industry are unlikely to be able to meet, or that it will cost them much more that the domestic industry to meet? Or if the government subsidizes domestic production of steel? All these policies would improve the competitiveness of domestic steel producers with respect to foreign producers and the market access that foreign governments had expected to gain through the bound tariff reductions will be partly or entirely offset.

Although the above-mentioned policy instruments can have similar effects on trade as tariffs, they are unlikely to be perfect substitutes. It has been shown in the literature, that in this case, governments will anyway be tempted to use the imperfect domestic policy to substitute for tariffs, but that the resulting overall level of protection will be lower than if countries were entirely unconstrained in the use of

80 See Howse (2002).

81 See Petersmann (1996).

82 Example taken from Howse (2002).

protectionist measures.[83] In other words, trade agreements with "loopholes" are better than no trade agreements. This argument may, however, not hold for all individuals within countries. If, for instance, government policies are mainly influenced by producer interests, consumers may end up carrying the major part of the burden created by the negative efficiency effects of alternative "trade" policies, while producers take advantage of the protectionist effects of those policies. As a consequence consumer interests may not necessarily be served by agreements that completely eliminate tariffs, because other, more costly instruments may be substituted for tariffs.

Even though agreements with loopholes lead to more liberalization than no agreements, one may want to consider keeping the loopholes as small as possible in order to encourage trade liberalization by limiting the ability of members to replace tariffs by altered "domestic" policies. A failure to do so could not only imply that tariff negotiation lead to little market opening, but could also contribute toward inefficient domestic policy choices. This is the case, because many internal measures are used to pursue policy objectives that are not trade related. Labour legislation may for instance be used for redistributive purposes or to provide security against adverse professional events to workers. Environmental standards are used to remedy environmental production or consumption externalities. If those policies are suddenly also used for protectionist motives, governments could end up trading off protectionism against those other policy objectives. It has been shown that this could eventually lead to a "race-to-the-bottom"-type problem, as governments lower domestic standards in order to raise competitiveness of domestic producers and thus constrain the market access provided to foreign producers through tariff reductions.[84] Countries would thus end up with inefficient domestic policy instruments and levels of trade that are lower than optimal.

(ii) Approaches to discipline the use of internal measures

Having identified the inefficiency associated with unilateral policy choices, the question arises how negotiations could address this inefficiency. In theory, one could consider that governments negotiate directly over all the domestic policy instruments available that could potentially affect market access and design specific disciplines for each of them individually.[85] Although it looks like an entirely unrealistic task to do so for all possible domestic policy measures, WTO Members have arguably chosen to follow the approach of designing specific disciplines for some domestic measures, i.e. intellectual property rights and sanitary and phyto-sanitary measures.

A related approach would be to device general rules that allow trading partners only to use so-called "first best policies" to target market imperfections like environmental externalities or information asymmetries.[86] A "first best policy" is a policy that corrects an existing distortion in the market and that, off all possible remedies to the problem, is the best approach to correct the specific distortion. Any deviation from the "first best policy" would be forbidden. Such an approach would allow governments to reach desired levels of market access by bargaining on trade barriers, like tariffs, only. This approach has two potential problems. First, while the "first best policy" may be a well defined concept in a theoretical model it is in real life often difficult to define what a first-best intervention would be. Second, it has been pointed out in the literature that such an approach can lead to a "war between public orders".[87]

An alternative approach suggested in the literature, the so-called "targeting approach" does not have these disadvantages.[88] According to this approach governments negotiate over the levels of market access

83 See Copeland (1990).

84 See Bagwell and Staiger (2002).

85 See Bagwell and Staiger (2001), Howse (2002).

86 E.g. Mattoo and Subramanian (1998).

87 See Bagwell et al. (2002).

88 This approach has been developed in Bagwell and Staiger (2001) and is further explained in Bagwell and Staiger (2002) and Bagwell et al. (2002).

they are willing to deliver and then each of them decides unilaterally on the best policy mix of tariffs and internal measures with which to deliver the agreed-upon access to its markets. Legal provisions need to guarantee that negotiated market access commitments are secure against unilateral infringement, where such infringement may derive from adjustments in tariffs or standards.

It has been argued that this targeting approach can deliver desired outcomes, even if direct negotiations only concern tariffs.[89] Taking and initial standards as given, governments can negotiate tariffs that would achieve the desired level of market access. Subsequent to this negotiation, if a government seeks to lower its standards from the initial level, it can, provided that it also lowers its import tariff so as to maintain its market access commitment. However, legal provisions would also need to allow countries to raise standards without changes in their market access commitments. In other words, if a government seeks to increase its standard – for instance because of changes in the importance given to environmental problems – it would be permitted to raise its import tariff and thus maintain its market access commitment. If legal provisions were to allow for such an approach, each government would remain free to reconfigure its policy mix in the preferred manner after having negotiated market access levels, as long as any new policy mix fulfils the negotiated market access commitments.

All three approaches discussed in the economic literature are reflected in the WTO Agreements. As indicated before, WTO Members appear to have chosen the first approach, the one of setting explicit disciplines for internal measures, in the TRIPS and to a lesser extent in the SPS Agreement. This approach will be discussed in more detail in Section D.6 of this Report. The second approach has typically been linked to the legal concept of national treatment and, in particular, to GATT Articles III and also XX. The third approach, instead, is linked to the legal concept of "nullification or impairment" and has therefore often been discussed in the context of GATT Article XXIII.

(b) Disciplining the use of trade distorting policies under WTO Agreements

In order to protect the agreed tariff reductions as well as the reciprocal "balance of concessions" from being undermined by non-tariff trade barriers or by other governmental measures, trade agreements, like the WTO Agreements, often make use of one, or a combination, of three complementary legal techniques:[90] (i) substantive legal rules prohibiting or limiting the use of trade restricting or distorting trade policy measures; (ii) procedural rules providing for legal remedies not only in case of treaty violations but also in situations where the commercial opportunities protected by those trade agreements were being nullified by other (e.g. purely domestic) measures; and (iii) termination clauses allowing a disappointed party to terminate the trade policy obligations altogether on short notice (mostly three to six months).

(i) National Treatment

In the GATT the first legal approach is reflected in Articles III and XX. GATT Article III provides a non-discrimination norm to distinguish acceptable from non-acceptable non-trade internal measures, i.e. the national treatment principle.[91] The concept of national treatment implies, that once imported goods have entered the domestic market, they should in principle not be treated differently from domestic goods. In other words, goods that can enter a country's territory thanks to reduced border barriers, should not be discriminated against once they have entered that territory. Article III thus reflects the awareness of treaty writers that internal measures have the potential to substitute for border barriers and Article III is meant to avoid such practices. The most relevant text of this Article is reproduced in Box 10.

89 See Bagwell et al. (2002).

90 See Petersmann (1996).

91 See Howse (2002).

Box 10: GATT Article III "National Treatment on Internal Taxation and Regulation"

1. The Contracting Parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

Interpretative note to paragraph III.2:

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, purchase, transportation, distribution or use....

The legal text indicates that imported products should not receive treatment that is "less favourable" than the treatment given to "like" domestic products. It also indicates that internal measures should not be applied "so as to afford protection" to "directly competitive or substitutable products". The degree to which the use of internal measures is disciplined through GATT Article III depends to a large extent to the interpretation given of the terms "like" product, "directly competitive or substitutable product", "no less favourable than" and "so as to afford protection".[92] All four terms have played a prominent role in GATT and WTO disputes.[93]

In order to secure that the gains from negotiations are not undermined by internal measures, WTO Members also need to be ensured that internal measures are applied on an MFN basis. The MFN obligation of Art. 1 GATT, therefore, applies to any kind of duty, administrative procedure, etc. that affects trade in goods. WTO Members must automatically and unconditionally apply MFN to goods and services from their trading partners. However, its ambit is limited by one restriction: it only applies to "like" products, a term also appearing in several other MFN clauses in the WTO Agreements. Again, the interpretation of the term "likeness" is a crucial issue as narrow definitions of likeness open up greater opportunities for discrimination than broader ones. In the context of GATS the additional question arises, whether MFN must only be applied to "like" services or also to service suppliers that are "alike". The existence of four

92 See, for instance the discussions in Ehring (2002) and Marceau and Trachtman (2002). The interpretation of the terms "likeness" and "no less favourable than" have, for instance, played a role in *EC-Asbestos* and in *Korea-Various Measures on Beef*. The term "directly competitive or substitutable" has been interpreted in *Japan-Alcoholic Beverages II*, *Korea-Alcoholic Beverages* and *Chile-Alcoholic Beverages*. The interpretation of the term "so as to afford protection" played a role in *US-Taxes on Automobiles*, *US-Malt Beverages* and *Japan-Taxes on Alcoholic Beverages*.

93 Neven (2001) argues that legal texts appear to make a distinction between "like" products and "directly competitive and substitutable" products, but argues that the distinction between "like" and "directly competitive and substitutable" products is not warranted from an economic point of view. Instead, when determining the extent to which domestic firms are protected, one should jointly consider the degree of substitution between domestic and foreign firms and the degree of rivalry in the domestic market.

modes of supply adds to the complexity and it is tempting to conclude that "... the concept of likeness of products ... is more elusive in services than in goods."[94]

Economists have interpreted the implications of Article III in different ways. According to Ederington (2001) the legal texts amount to a blanket proscription of the use of internal measures as a form of protection. He contrasts this treatment of internal measures with the provisions in GATT Articles I and II, which cover trade barriers and which only require that tariff protection does not exceed any "binding levels" that Members may agree to in the GATT negotiations. According to Ederington (2001) this differential treatment reflects a broad presumption that protection in the form of tariffs is preferable to protection in the form of internal taxes or regulations. He argues that this approach makes sense from an economic point of view and shows that when limited enforcement power prevents countries from implementing a fully efficient set of trade and internal measures, countries should set the internal measures to fully counter any domestic distortion and adjust trade policies to maintain the viability of the agreement. Given that the sole international externality in his framework is the terms-of-trade effects of a government's policy decision, the sole reason for defection is to pursue terms-of-trade gains. Therefore, the most efficient means of countering the incentive to deviate from the agreement and to guarantee the stability of the agreement, is to relax only on trade policy, which in the set-up of Ederington (2001) means that countries can use trade policy to retaliate against those who deviate from the agreements.

Ederington's (2001) interpretation of the GATT legal texts is thus that they manage to eliminate the use of internal measures for protectionist motives, but his analysis implies that the texts allow Members to use first-best-policies to counter distortions in domestic markets. Other economists interpret Article III differently. Horn (2006) argues that it is reasonable to assume that Article III implies that WTO Members are not allowed to levy higher international taxation on imported products than on domestically produced products, regardless of the motive. In other words, Members are not allowed to use internal measures for protectionist motives, but they are also not allowed to differentiate between domestic and imported goods to counter any domestic distortions. Horn (2006) argues that such an approach makes sense from an economic point of view as domestic distortions would normally not justify differential treatment of domestic and imported goods. This would only be justified if the distortion occurs at the border and in this case tariffs would be the optimal instrument to counter the distortion and policy makers should take this into account when negotiating tariff reductions. The author, however, acknowledges that it is not very realistic that negotiators will manage to do so. If they don't, then Article III interpreted in a strict way, i.e. implying that Members are under no circumstances allowed to treat imported "like" products different from domestic products, could potentially impede governments ability to apply appropriate internal measures to counter distortions introduced by imported products.

According to Howse (2002), GATT drafters introduced GATT Article XX in recognition of the fact that the rather general non-discrimination norm in Article III may not in all cases be an adequate dividing line between "legitimate" public policies and "cheating" on trade liberalization commitments. Article XX, therefore, provides explicit exceptions for policies that may even entail elements of discrimination, provided that they are justified in terms of certain, explicitly listed, non-protectionist goals and that their application does not entail *unjustified* or *arbitrary* discrimination. GATT Article XX, for instance, stipulates that measures "necessary to protect human, animal or plant life or health" and measures "relating to the conservation of exhaustible natural resources" can be adopted.[95] The word "necessary" is important in this context, as it has been interpreted in terms of a "necessity test", in the sense that

[94] Quote taken from Cossy (2006) who refers to "Subsidies and Trade in Services, Note by the Secretariat, S/WPGR/9, 6 March 1996.

[95] The fact that rules to avoid circumvention through domestic policies were included in the original GATT texts reflects how important they are in order for trade cooperationeration to function. From this point of view it may seem surprising that one area of government intervention is excluded from the GATT. This area is government procurement. Government purchases of goods and services represent an important part of economic activity in many countries. If domestic suppliers are favoured over their foreign competitors in public procurement this can therefore have significant effects on trade flows. This explains while government procurement has been dealt with in a separate agreement, albeit it is a plurilateral agreement not covering the entire WTO membership.

measures that claim to target the protection of human, animal or plant life or health can only be used if it can be shown that they are "necessary" to achieve this protection.

Other provisions in WTO Agreements have gone further in defining guidelines to distinguish between "legitimate" public policies and policies that are there to cheat on trade liberalization. It has, for instance, been argued that the SPS Agreement should be understood, to some extent, as an expansion of Article XX of GATT, as its drafters were concerned with the need to (i) expand the scientific and procedural requirements for a Member to impose an SPS measure and (ii) encourage reliance on, and participation in, international standard-setting bodies.[96]

The approach taken in the SCM Agreement differs somewhat from the general approach taken in the GATT. The SCM Agreement disciplines the use of subsidies that are "specific" according to the definition given in Article 2 of the Agreement. Most notably, a subsidy is to be considered "specific" if access to it is explicitly or implicitly limited to certain enterprises.[97] A subset of "specific" subsidies faces outright prohibition through the Agreement. This is the case for subsidies contingent on export performance or on the use of domestic over imported goods. Note that such subsidies are in fact explicitly trade-based policies, which explains why they receive different treatment from other "specific" subsidies. Other "specific" subsidies are considered to be "actionable", which implies that they can either be challenged via the WTO dispute settlement or subjected to countervailing measures if they can be shown to cause specified adverse effects to the interests of another country (including injury to the domestic industry of the country importing subsidized goods, or distortion of trade flows).

(ii) Legal remedies in case of nullification or impairment

The GATT legal texts also contain procedural rules representing the second and third legal technique mentioned above in that they provide for legal remedies in situations where the commercial opportunities protected by those trade agreements were being nullified by other measures and that they contain a termination clause allowing a disappointed party to terminate the trade policy obligations altogether.

GATT drafters recognized that it would be next to impossible to catalogue all potential trade distorting policy measures in advance and it was therefore suggested that trade agreements should have another more general provision which would address itself to any other government action that produced an adverse effect on trade benefits accruing under the covered agreements.[98] This eventually led to the inclusion of a provision for non-violation nullification-or-impairment complaints in GATT Article XXIII. GATS contains a similar provision in paragraph (3) of Article XXIII.

Paragraph 1(b) of GATT Article XXIII provides for a right of redress where, even though it does not violate a specific provision of the GATT, a Member engages in actions that undermine the value of negotiated concessions under the GATT. As drafted, GATT Article XXIII:1(b) could be read as providing a basis for requests for compensation, where policy changes adversely affect the value of negotiated concessions.[99] However, under Article 26 of the Understanding on Rules and Procedures Governing the Settlement of Disputes, complainants face a particularly high burden of proof when challenging an internal measure under GATT Article XXIII and need to establish a causal link between the relevant internal measure and the nullification or impairment of a negotiated concession.

96 See also Section D.6 on the SPS Agreement.

97 Article 2.1(b) of the SCM Agreement specified that specificity shall not exist where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. A footnote to this article further explains that objective criteria or conditions mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise.

98 See Hudec (1990).

99 See Howse (2002).

According to the economic arguments developed in Section 1 above, the concept of non-violation complaints may provide a basis for requests by a GATT/WTO Member for redress whenever it can show that market-access commitments which it had previously negotiated are being systematically offset as a result of an unanticipated change in the policies – policies not necessarily excluding, for example, labour and environmental standards – of another GATT Member, even if such policy change is not in breach of any GATT rule but merely undermines the value of trade benefits arising under covered agreements.[100] If a non-violation complaint is successful, the complaining country is entitled to a rebalancing of market-access commitments, wherein either its trading partners find a way to offer compensation for the trade effects of its domestic policy change (typically in the form of other policy changes that restore the original market access) or the complaining country is permitted to withdraw an equivalent market-access concession if it obtains prior authorization by the DSB.

GATT/WTO jurisprudence suggests that a complainant must establish four conditions in order to be successful with a non-violation complaint. These conditions are: (1) a concession has been negotiated; (2) a subsequent measure is applied by a WTO Member; (3) the complainant could not have reasonably anticipated the application of the measures at the time the concession was negotiated; (4) the value of the negotiated concession has been nullified or impaired as a result of the application of the challenged measure. Throughout the GATT years, the "subsequent measure" involved, in all but one case, the granting of a subsidy to a domestic producer that led to import substitution.[101] In the WTO-era, the *Kodak-Fuji* litigation illustrated that also regulatory subsidies can be the object of a non-violation complaint. At the same time, the *Kodak-Fuji* panel emphasized that the non-violation remedy should be approached with caution and should remain an exceptional remedy. The panel explained that the reason for this caution is that WTO Members negotiate the rules that they agree to follow and only exceptionally would expect to be challenged for actions that are consistent with those rules.[102] Bagwell et al. (2002), however, argue that this approach does not necessarily define fully the scope of potential application of the non-violation concept. They refer, in particular, to the *Asbestos* report, in which the Appellate Body rejected the argument that certain types of measures, such as those with health objectives, are excluded from the scope of application of Article XXIII:1(b).[103]

(c) Reconciling economic and legal approaches

Most disputes concerning the effect of internal measures on market access have been based on GATT Articles III and/or XX, or on WTO Agreements that concern specific domestic measures like the SPS Agreement, the TBT Agreement or the SCM Agreement. The relevant legal provisions give guidelines on how to distinguish a legitimate domestic policy from one that is not legitimate. In economic terms, first best policies, i.e. policies that are the best remedy to correct a domestic market failure, should be considered legitimate. The question whether existing legal texts allow for an interpretation that corresponds to economic thinking has been debated in the relevant literature and different answers have been given to this question. Assuming that the question can be answered in the affirmative, another difficulty is to know in practice which policy can be considered to be a first-best-policy in a given situation of dispute. It has been pointed out in the literature that this approach can lead to a "war between public orders", given that optimal policies depend on characteristics that may be country specific like consumer preferences, moral value or cultural heritage.

Recent contributions to the economic literature have therefore argued in favour of a more extensive use of Article XXIII. That literature has, however, also pointed out that the possible use of Article XXIII would need to be extended. Currently, if subsequent to tariff negotiations a government wished to change its domestic standards in a way that would effectively grant greater market access to its trading partner at existing tariff levels, under the WTO rules it would not have the flexibility to unilaterally raise its tariff so as to secure market access at the negotiated level, and so in this case efficiency cannot be achieved by tariff negotiations. Instead, the current set-up has the potential to lead to a phenomenon of "regulatory chill", as governments do not

100 See Hudec (1990).

101 See Bagwell et al. (2002).

102 See Japan-Measures Affecting Consumer Photographic Film and Paper, WTO document. WT/DS44/R (March 31, 1998).

103 Reference to AB report.

endeavour to raise standards out of concern about the competitive position of their producers. Bagwell and Staiger (2001) argue that giving this additional flexibility in the context of the WTO Agreements would ensure that governments could achieve efficient trade and domestic policy outcomes with tariff negotiations alone. The fact that Members and legislators have so far been rather hesitant to use Article XXIII may, however, be an indication that the suggested approach has more appeal at the theoretical than at the practical level.

4. CONTINGENCY

(a) Explaining contingency measures in trade agreements

In the received theory of international trade cooperation, contingent provisions are unnecessary if renegotiation is always possible. Given an initial level of reciprocal liberalization, a change in conditions for one of the parties that requires it to increase the level of protection can be accommodated if it is able to offer some compensating liberalization which leaves its trade parties as well off as before. This requires providing an explanation for the presence of contingency rules in trade agreements.

One explanation is that contingent protection is nothing but protectionism. The presence of contingency measures could be explained by the political economy of protectionism (Tharakan, 1995). Trade liberalization around the world has reduced tariff rates to very low levels. The losers from this process have an incentive to secure protection through the political process and politicians may not be too reluctant to meet the demand. Now, contingent measures are typically administered by bureaucracies, which appear to be insulated from political influence. But political influence can be brought to bear on this process by shaping the laws and regulations which govern the work of these bureaucracies (Finger et al., 1982). Indeed, empirical research substantiates the role played by political influence in affecting the decisions taken by these agencies, particularly in the case of injury determination (Schuknecht, 1992; Tharakan and Waelbroeck, 1994). Furthermore, the ambiguities inherent in these contingent events give substantial leeway for bureaucracies to interpret the evidence. So it may not be surprising that falling tariffs have coincided with the more frequent and wider use of trade contingent measures, particularly anti-dumping. In this view, the presence of contingent measures in trade agreements represents the substitution of one form of protection for another.

Barton et al. (2006) have a less cynical view about trade contingent measures. They regard contingency measures as policy instruments that are used by well-meaning policy makers to manage the redistributional effects of more open trade. Trade liberalisation produces winners and losers in a country. However, countries typically do not have identifiable mechanisms for extracting part of the income gains from the winners in order to compensate the losers from trade liberalization. Contingency measures fill this void by providing governments a way to shield vulnerable sectors from the consequences of lower tariff protection.

Jackson (1997) suggests two possible explanations for contingency measures. The first explanation sees contingency measures as a tool to lower the costs of economic adjustment arising from liberalization. Trade liberalization requires resources to move from sectors where a country does not have comparative advantage to sectors where it does have comparative advantage. Such an adjustment may sometimes be difficult to make, with workers facing long spells of unemployment. Temporary protection can be employed to slow down the entry of imports providing time for domestic industry to adjust to the effects of competition. However, he also acknowledges the difficulties with this explanation since trade measures are not necessarily the most efficient ways of facilitating adjustment. Domestic measures to enhance the mobility of workers and of firms would be preferable.

This leads to his second explanation which sees contingency measures as pragmatic tools to deal, not with the cost of adjustment itself, but with the political demands for protection that it provokes. If nothing is done, political pressure may build up to a point where protectionist forces would be able to engineer a permanent reversal of trade liberalization. The introduction of contingency measures in a trade agreement may be thought of as anticipating the possibility of such difficult adjustments and the political pressure for protectionism that they give rise to, and providing a means to deflate this pressure with a temporary reversal of liberalization.

This view implies that the depth of liberalization that can be achieved by a trade agreement *ex-ante* may depend on whether there are built-in escape clauses that recognize the uncertainty in the economic environment. Trade agreements involve governments making commitments on policies that will apply not only at the present time but also in the future. But economic circumstances in the future may evolve in a way which makes maintenance of the present policy untenable because of large adjustment costs. Trade agreements will need to provide governments a means to depart temporarily from the provisions of the trade agreement under well defined and circumscribed conditions. The presence of contingency measures addresses this need. While the use of the contingent measures may result in ex-post welfare losses during periods when the level of protection is temporarily increased, the deeper liberalization that is allowed ex-ante means that this is outweighed by the long-term welfare gains.[104]

(b) Scope of contingency measures

One issue to contend with is the scope of contingency actions. Is it limited only to safeguard or emergency actions or is it also necessary to include actions i.e. anti-dumping and countervailing duties in response to certain types of practices sometimes referred to as "unfair" trade practices?, to the extent that foreign trade practices or policies, irrespective of whether they are fair or unfair, result in increased imports and injury to domestic injury, they can generate domestic demands for protection that may put liberal trade policies at risk. Thus, they give rise to precisely those conditions that contingent measures are meant to address. Hence, safeguard, anti-dumping and countervailing measures are alike to the extent that they can be employed to deflate the build-up of domestic pressure against trade liberalization. Some of the differences in these trade contingent measures, including the conditions under which they can be invoked, are discussed in the subsection below.

A second reason why it may be necessary to include anti-dumping and countervailing duties in the scope of contingency measures is the heavy reliance on them (particularly anti-dumping actions) by countries (see Table 3). Using the notifications made by Members to the WTO, over the 1995-2005 period, safeguard measures were the least relied on. There were 20 times more anti-dumping initiations (2,851) than there were safeguard initiations (142) and nearly 26 times more anti-dumping measures (1,804) than there were safeguard measures (70) applied.[105]

Table 3
Trade contingent actions, initiations and measures, 1995-2005

Trade contingent instrument	Initiations	Measures
Anti-dumping	2,851	1,804
Countervailing measures	182	112
Safeguards	142	70

Source: WTO Secretariat.

Finally, there is a strong link between periods of economic distress and anti-dumping activity. Knetter and Prusa (2003) have found that for four of the major users – Australia, Canada, the EC and the United States – anti-dumping filings were closely correlated with macroeconomic activity and real exchange rate appreciation. Periods of real exchange rate appreciation can lead to a loss of competitiveness in import-competing sectors, thus, triggering a larger flow of imports. Economic downturns cause increased joblessness and financial losses for companies. They contribute to conditions that make anti-dumping measures very attractive for the affected firms.

[104] Finger and Nogues (2005) make a similar point in their examination of the Latin American experience with trade liberalization that "in the larger political context, anti-dumping and safeguards are a necessary quid pro quo to certain important sectors to obtain much more liberalized trade policies for the general economy".

[105] It should be noted though that a safeguard action may involve multiple import sources.

Thus, it could be argued that countries have found anti-dumping rather than safeguard measures the preferred instrument for adjusting to trade difficulties and letting off protectionist steam. So, for the purpose of this discussion all three types of trade remedies will be considered as contingent measures.

(c) Contingency-related provisions in the multilateral system

At the multilateral level, the most important contingency provisions are to be found in GATT Articles VI (Anti-dumping and Countervailing Duties) and XIX (Emergency Action on Imports of Particular Products) and the corresponding multilateral agreements – Anti-Dumping Agreement[106], Subsidies and Countervailing Measures Agreement and the Agreement on Safeguards. The classification of anti-dumping and countervailing duties as contingency measures is partly because of the heavy reliance on anti-dumping actions by countries as is shown in Table 3 above.

But there are other relevant GATT Articles which could also be considered contingent measures. Among these are GATT Articles XII (Restrictions to Safeguard the Balance of Payments) and XXVIII (Modification of Schedules). The latter allows a WTO Member to increase its bound tariff, subject to providing "compensatory adjustment" to affected trade partners.

Finally, one should also note the practice of some WTO Members of using the margin between the bound and applied tariff rates as a de facto trade remedy. The applied tariffs are increased to shelter domestic industries from imports but not to the extent that they move above the bound rate so that no WTO commitment is breached.

Although safeguard, anti-dumping and countervailing duties have been lumped together as contingency measures, there are important differences among them.

Anti-dumping and countervailing measures can only be invoked against imports traded at dumped prices (i.e., below their "normal value"), or subsidized imports, respectively and subject to showing that domestic industry has suffered material injury caused by those imports. A country can apply a safeguard measure against increased imports even though those imports are not dumped or subsidized or otherwise subject to a particular trade practice, if those imports are the cause of serious injury to its domestic industry.

Because dumping or subsidization may be supplier- or country-specific, anti-dumping and countervailing measures are imposed only on those suppliers whose products are found to be dumped or subsidized, i.e., the measures are not applied on an MFN basis. Safeguard measures are in principle applied on an MFN basis, i.e., are meant to apply to all sources of imports, although developing countries can be excluded from their application if those countries account for a small share of imports.

Finally, since anti-dumping and countervailing measures are applied in response to specified trade practices (dumping or subsidization), there is no requirement to offer compensation to the affected trade partner. In contrast, a country applying a safeguard measure – which is in response to an import surge that has harmed its domestic industry, rather than in response to the effects of a particular trading practice – has to offer compensation for the adverse effects of the measure on trade partners.[107]

Some of these differences between anti-dumping and safeguard actions have been identified as the reasons why countries have a preference for using the former. The non-discriminatory feature of safeguard measures has been cited as one reason why this instrument is used less frequently, because governments preferred a more targeted instrument that could be directed at the country or set of countries that are the source of the injury (Barton et al. 2006). The reluctance of countries to use safeguard measures also

[106] The formal name of the Anti-Dumping Agreement is the *Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994*.

[107] The Agreement on Safeguards provides for a modulation of this general rule, however, in the sense that Article 8.3 prevents Members subject to a safeguard measure from retaliating for the first three years that a measure is in effect provided that the measure has been taken as a result of an absolute increase in imports.

has been linked to countries' aversion to legitimize a protectionist measure that is applied on fairly traded goods as well as to the requirement that compensation be paid (Jones, 2004). This last point hints at an inefficiency that could arise from the use of anti-dumping, rather than safeguards, as a contingent measure in the sense that the former does not leave trade partners as well off as before.[108]

(d) Contingency-related provisions in regional trade agreements

Testifying to the value of contingency measures in international trade agreements, the great majority of the RTAs continue to allow the use of trade remedies in intra-regional trade (Teh et al., 2007). The study examined the trade contingent measures in 74 RTAs, which varied in size, degree of integration, geographic region and the level of economic development of their members. Only a handful of RTAs have achieved abolition of trade contingent measures, although this included the largest RTA, e.g. the European Communities.

The continuing importance of contingent measures in RTAs reflects the balancing act that governments need to perform when committing to additional liberalization in a free trade agreement. Since the decision to establish an RTA has as an objective the dismantling of all barriers to regional trade, this creates new demands from import-competing sectors for protection. To preserve political support for the RTA, governments typically bundle in restrictive rules of origin, long transition periods and sensitive sectors in the agreements. Governments may find the continued existence of trade contingent measures also necessary to preserve political support for the regional trade agreement.

What about those RTAs which have been able to abolish trade contingent measures? These RTAs are characterized by deeper forms of integration that go well beyond the dismantling of border measures; a common external tariff and a higher share of intra-RTA trade (Teh et al., 2007). Thus, the need for contingent measures in trade agreements may also be a function of the degree of economic integration contemplated by the members. If the goal of deeper integration is shared by the political leaderships and peoples of the members, the risk of protectionist forces being able to mount a reversal of economic openness may be much less. Deeper integration is also likely to result in greater coordination, harmonization and even adoption of common regulations, policies and institutions, which allow the countries to better absorb the costs of adjustments from openness to trade.

5. RULES OF ENFORCEMENT AND DISPUTE RESOLUTION

Any trade agreement, in fact, any contract needs (implicit or explicit) rules of enforcement. In the absence of a supra-national authority, most trade agreements must rely on self-enforcement. However, self-enforcement need not be synonymous to the rule of force, but may be an orderly, rules-based process. After giving a short introduction into the basics of enforcement, this subchapter discusses rules of enforcement and dispute settlement.

(a) The basics of enforcement

"[T]he WTO Agreement is a treaty – *the international equivalent of a contract*."[109] Contracts are best defined as a mutual exchange of commitments over time (Craswell, 1999; Dunoff and Trachtman, 1999). Every contract needs to be enforceable, since enforcement gives credibility to the mutual commitments made and deters defection. Without enforcement a contract can be expected to break down, or, more likely, would not have been concluded in the first place.[110]

[108] As noted above, however, Article 8.3 softens the retaliatory rights of affected Members, thus reducing the instances in which compensation must be paid by the Member taking the safeguard action.

[109] Appellate Body Report, *Japan–Alcoholic Beverages II*, (WT/DS8,10,11/AB/R: 16, emphasis added).

[110] Masten (1999: 26) notes: "Without some form of assurance that others will, when the time comes, uphold their end of the bargain, individuals will justifiably be reluctant to make investments, forgo opportunities, or take other actions necessary to realize the full value of exchange".

Enforcement is a function of "enforcement capacity" and "enforceability". Enforcement capacity is the ability to reciprocate credibly against a violation of the terms of the contract. Enforcement can be exercised by the affected party itself (self-enforcement), by a neutral third-party,[111] by society at large or through collective enforcement by a circle of affected or interested parties (such as the membership of a multilateral contract). Enforcement instruments can vary from physical (incarceration), economic (penalty fees) to emotional (reputation loss) measures. Enforceability has three components: observability, verifiability and quantifiability. Observability means that infringements can be detected in the first place – either by the affected party itself or by a third party. A contract violation is verifiable if the affected party can point to a clause in the contract and prove its violation. This presupposes that such a clause is contained in the contract and/or that the violation can be determined by a neutral third party. Finally, quantifiability, implies that the aggrieved party (or a court) can quantify the damage incurred as a result of the breach of the contract.[112]

(i) The level of cooperation and the level of enforcement

Every contract is driven by the desire to cooperate. Parties enter into contractual relationships with the aim of minimizing costs, engaging in risk transfer and/or reaping transaction efficiencies. Cooperation may not be a binary issue, but a matter of degrees. In Chart 3 various degrees of cooperation (C) are plotted on the horizontal axis, where (C^{max}) refers to full cooperation and (C^{N}) to the absence of cooperation. The Chart shows a contract between two players,[113] assumed to cover a long-term relationship with repeated interaction (such as a trade agreement). Each contracting party has an incentive to cheat by deviating from the terms of the agreement. The short-term benefit from defection is called hit-and-run advantage *H&R*.[114] The vertical axis depicts the utility gain in excess of a situation without a contract, i.e in excess of U^{N}.[115] The hit-and-run benefit (if seized by the potential defector) is by definition an opportunistic, that is, inefficient redistribution of welfare to the detriment of the affected party.

Chart 3 displays two mechanisms to enforce continued cooperation.[116] In case of self-enforcement (i.e. no superior enforcement body exists), the affected party exits the agreement (the threat of reverting to the pre-contractual non-cooperative "Nash equilibrium" is also called a "grim trigger" strategy of enforcement). The curve *S-E* ("self-enforcement") in Chart 3 represents the injurer's opportunity costs of reprisal, that is, the discounted value of cooperation.[117] It is the sum of future benefits from cooperation that the injurer foregoes from having defected and prompted the grim trigger response. The potential defector balances the short-term incentive to cheat with the long-term cost from an infinite suspension of cooperation. As the level of cooperation increases, the costs of reprisal exceed the hit-and-run gains from one-time defection until the two curves intersect at C^{SE}, which can be defined as the "most cooperative" cooperation level that can be sustained through self-enforcement. Beyond this point, the gains from one-time infringement of the agreement exceed all the compiled future gains of cooperation. Beyond $C^{S\text{-}E}$ it is irrational for the injuring party

111 Third-party enforcement may be called "court-and-copper" enforcement, since constitutional states require that a jurisdiction (judge) determines a legal infringement and an executive (police) enforces the law.

112 Quantifiability may be important where there is no *prima facie* violation of the rules, or in seeking retaliation.

113 For simplicity, parties are assumed to be symmetrical. Therefore, only one contractor needs to be examined, since the incentives and actions by the other are identical. This is without loss of generalization: In a model with multiple actors, the enforcement can always be represented as a two-player game, namely between a player "X" and a player "rest of the world".

114 The hit-and-run gain is the additional utility the injurer enjoys from defecting over cooperating as promised. It is a short-term benefit, since it merely stretches from the moment of defection until the time the violation is detected.

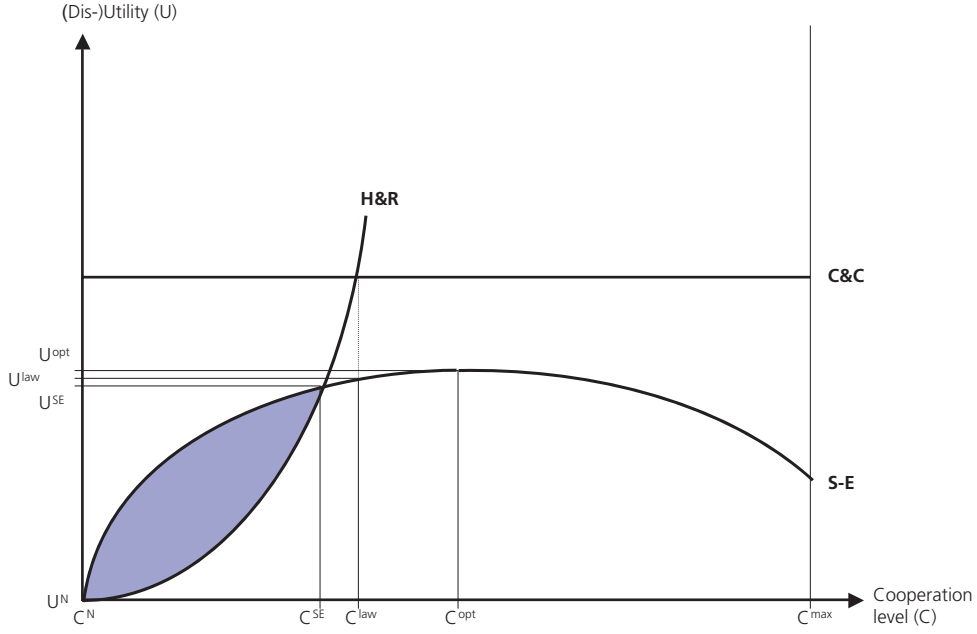
115 The convex curvature of line *H&R* is intuitive (increasing marginal return from defection), but not necessary. Bagwell and Staiger (2002: 102) provide some arguments in favour of this curvature for the case of the "contract" being a trade agreement. The curve is flat and equal to zero at C^{N}, where the contracted cooperation is equivalent to the situation without agreement.

116 Other kinds of enforcement are possible, but are not considered here, since they are just variants of the two explained mechanisms.

117 The discounted value of cooperation is the sum of all future per-period extra-gains from having a contract (*vis-à-vis* having no contract at all). Again, the concave curvature of the *S-E* curve is intuitive (more cooperation in every round is beneficial up to some optimal point C^{opt}). After that point more cooperation has declining, possibly negative returns, for example because of a loss of freedom and sovereignty. See Bagwell and Staiger (2002: 102) for the case of a trade agreement. The *S-E* curve also must go through the origin: The more the contracted cooperation level approaches the no-contract (Nash-cooperation) level, the smaller are the future gains from cooperation.

to comply ("binding constraint"). Anticipating the injurer's behaviour, it is equally irrational for the affected party to agree to a more cooperative deal, even though the welfare-optimal level of cooperation would be C^{opt} (due to symmetry of the players). Hence, without a central enforcement body, only the range between C^N and C^{SE} is self-enforceable yielding an additional utility in the range between U^N and $U^{s\text{-}e}$ (hatched area).

Chart 3
Enforcement constraint in contracts



Note: H&R stands for "hit-and-run". The H&R curve represents the discounted benefits of defecting from the terms of the initial contract. S-E stands for self-enforcement. The S-E curve represents the expected costs (disutility) of defection in a self-enforcing agreement. Those costs are tantamount to the foregone benefits from future cooperation. C&C stands for "court-and-copper"-enforcement. The C&C line is the expected disutility for defection (here, a liquidated damage clause) in a contract that is enforceable by an impartial third party.

Source: Graphical analysis by authors, based on Bagwell and Staiger (2002: 103).

If an enforcement body exists (a court to detect an infringement and coppers to enforce the court's verdict) contracting parties conclude their agreement in the "shadow of the law" (*C&C* in Chart 3).[118] Cooperation is more far-reaching (between C^N and C^{law}), because defection is punished immediately. For the injurer punishment results in a utility amounting to (*H&R – C&C*), which is negative everywhere below the cut-off point C^{law}. Third-party enforcement yields a higher mutual utility than the self-enforcement mechanism (U^{law} instead of U^{SE}). However, as drawn here, the shadow of the law can still not safeguard an optimal mutual cooperation C^{opt}, possibly because the law cannot enforce every little detail of the contract.

(ii) Factors favouring successful enforcement

Enforcement capacity and enforceability determine the strength of an enforcement mechanism and, hence, the scope of the agreement. Under a self-enforcement regime, an affected party's enforcement capacity depends on the injurer's time-value,[119] the affected party's enactment costs of retaliation[120] as well as its general ability to do harm to the injurer (Chart 4). Weak enforcement factors skew the injurer's opportunity-cost curve downwards (shown as the move from the dotted *S-E* to the solid *S-E'* curve in the Chart). Enforceability plays a role for

[118] The shadow of the law effectively stretches from C^N to C^{law}, i.e. over the entire contracting space. Beyond C^{law} no contract is possible, since defection is more attractive than legal punishment.

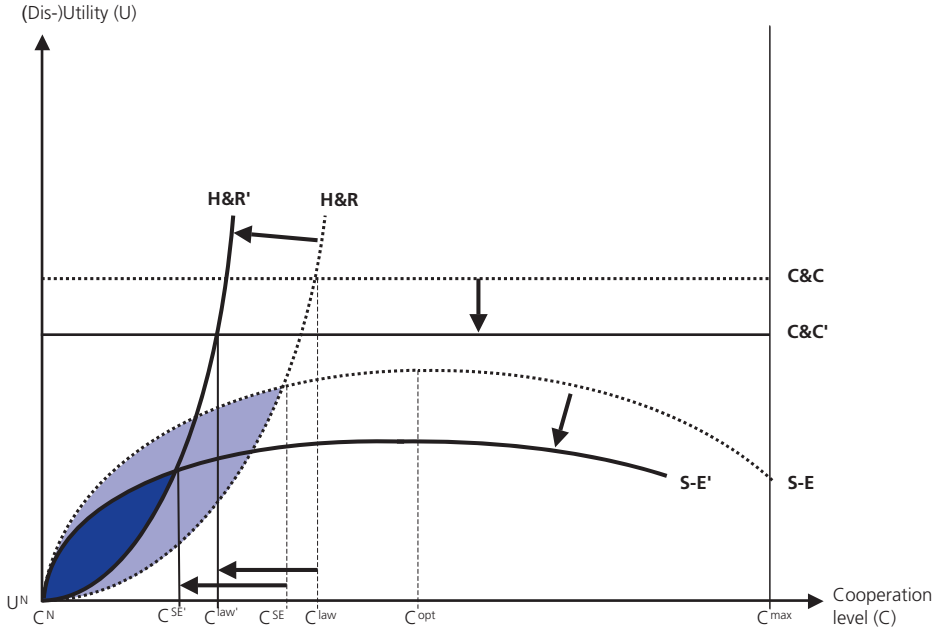
[119] The injurer's time value, or "discount factor" describes how much the injurer is interested in the current period *vis-à-vis* future periods. In the extreme case in which the injurer is only interested in today's utility and not at all in the future, a grim strategy has no deterrent effect. Therefore, no agreement would be signed.

[120] Any costs connected with enacting a sanction mitigate the victim's power (and willingness) to retaliate. For example, it is sometimes argued that a grim trigger strategy is costly to apply for the victim, since it is not only the defecting party that forgoes future benefits of cooperation, but also the punishing party.

the shape of the short-term hit-and-run curve. Insufficient observability, verifiability and quantifiability make one-time defection more attractive (the *H&R* curve gets skewed to the left, as illustrated in the move from the dotted line to the solid *H&R'* curve). For every level of cooperation, defection pays off more (higher defection utility). Fewer enforcement possibilities result in a smaller self-enforcement range and, consequently, as shown in Box 11, in a small range of ex ante cooperation (previous situation (hatched area) compared to scenario with insufficient enforcement (chequered area) determined by the intersections of the *H&R'* and *S-E'* curves).

Enforcement capacity and enforceability are equally important for contracts concluded under the shadow of the law: Under a weak "court-and-copper" regime (dotted *C-C* line shifts downwards to solid *C-C'* line) and with deficient detection and acquittal possibilities (yielding a leftwards shift of the *H&R* curve), the possible contract range shifts to the left from C^{law} to $C^{law'}$.

Chart 4
The importance of enforcement capacity and enforceability



Note: H&R stands for "hit-and-run". The H&R curve represents the discounted benefits of defecting from the terms of the initial contract. S-E stands for self-enforcement. The S-E curve represents the expected costs (disutility) of defection in a self-enforcing agreement. Those costs are tantamount to the foregone benefits from future cooperation. C&C stands for "court-and-copper"-enforcement. The C&C line is the expected disutility for defection (here, a liquidated damage clause) in a contract that is enforceable by an impartial third party.

Source: Graphical analysis by authors, based on Bagwell and Staiger (2002: 103).

(b) Self-enforcement in trade agreements

In the absence of a supra-national authority, any contract among sovereign nations must rely on self-enforcement.[121] Self-enforcement is not synonymous to vigilante justice, or a self-help system. In the anarchic system of vigilante justice, both ingredients of enforcement – enforceability and enforcement capacity – are in the hands of the affected party. This brings with it some considerable disadvantages: First, enforcement capacity entirely depends on a party's own retaliatory power ("size"). Second, each party (even larger ones) has to observe, verify and quantify the actions by other parties itself in order to detect and prove a contract infringement and calculate the damage incurred. Subjective assessments of that sort are not only costly, they can lead to disagreements over the nature, effects and consequences of a treaty violation between an alleged injurer and an affected party setting off threats of retaliation and

[121] Hippler Bello (1996: 417) states for the case of the WTO: "When a panel established under the WTO Dispute Settlement Understanding issues a ruling adverse to a member, there is no prospect of incarceration, injunctive relief, damages for harm inflicted or police enforcement. The WTO has no jailhouse, no bail bondsmen, no blue helmets, no truncheons or tear gas".

counter-retaliation and, possibly, a trade war.[122] Under an unconstrained self-help system countries can be expected to be reluctant to conclude an agreement or make wide-ranging commitments.[123]

(i) Rules of enforcement and dispute settlement in trade agreements

Aware of the tremendous disadvantages that a pure vigilante system entails, signatories to a trade agreement usually agree to bind themselves to a core set of enforcement rules and dispute settlement procedures. These rules prescribe the proper behaviour in case of disagreement over issues covered in the agreement.[124]

Codified rules of enforcement and dispute settlement can bring significant improvements over a purely vigilante system of enforcement:

- First, by laying down concrete mechanisms, procedures and timelines, rules of enforceability (observability, verifiability and quantifiability) are codified.[125] A rules-based system generates predictability and stability and injects confidence into the system;

- Second, the membership of a trade agreement may agree to enhance the enforcement capacity of weaker states by writing rules of collective or multilateral enforcement. Instead of leaving a small country alone in its effort to retaliate against a defecting member, willing affected (but non-litigating) or even all signatories may step in (see approaches by Maggi, 1999; Bagwell et al., 2007);[126]

- Finally, mutually agreed enforcement rules may prompt signatories to change their enforcement regime to more benevolent and less conflictual mechanisms. Examples include a move from a grimtrigger strategy of enforcement to a regime of commensurate punishment, or the possibility for lenient opt-out mechanisms in times of acute domestic crisis.[127] Another option is the choice of less trade-restrictive enforcement instruments, such as compensation in the form of tariff liberalization or monetary fees.

For all these factors rules of enforcement and dispute settlement may provoke higher levels of trust in the system by all signatories – small and big alike. Mutually agreed and codified rules can enhance enforcement capacity (an upward shift of the *S-E* curve in Charts 3 and 4) and increase the enforceability of the treaty, since defections are more easily detected, proved and punished (skewing the *H&R* curve to the right). This will reduce the potential for opportunistic defection and result in more extensive *ex ante* trade liberalization commitments by the members of the agreement.

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122 The risk for the breakout of a trade war may be factored in by signatories in their subjective discount factor.

123 See Chart 4 above. For small countries, a system of vigilante justice will push down the *S-E* curve (lacking enforcement capacity) and in addition skew the *H&R* curve towards the left, leaving a significantly diminished contract space.

124 Articles XXII and XXIII of the GATT, entitled "Consultation" and "Nullification and Impairment", respectively, are examples of rules of enforcement and dispute settlement.

125 In other words, rules of enforcement and dispute settlement lay down the contracting parties' common denominator of *what* exactly constitutes enforceable actions, *how* they can be detected and distinguished from lawful behaviour, *what* the calculative basis for indemnity (remedies) shall be, etc.

126 Maggi (1999) illustrates the advantages of multilateral over bilateral enforcements with a simply model. Three countries form a trade agreement. Each country exports a single unique good to each trading partner. It also imports two unique goods, one from each other country. However, a circular asymmetry in trade exists: Each country imports substantially more from one trading partner than it exports to that market. For example, country *A* sources most of its imports from *B* while exporting mainly to *C*. In a bilateral enforcement system, *A* cannot reciprocate against defector *C*, since it does not have the import leverage to inflict economic harm by retaliating against *C* through tariff hikes. In a multilateral system of enforcement, however, every country in the model will punish a defector. Country *C* is therefore reluctant to cheat against *A* knowing that *B* will punish it by raising the tariff against its product.

127 Many authors argue that in a repeated-game setting, a tit-for-tat strategy of enforcement is vastly superior to a grimtrigger response (e.g. Axelrod, 1984; Keohane, 1984; Oye, 1986). For the case of trade agreements this has been established among others by Sykes (1991), Downs and Rocke (1995), Ethier (2001). For a discussion of escape clauses as safety valves in trade agreements, see subsection 4 above. It is claimed that commensurate punishment and ready opt-out mechanisms increase the stability of the agreement, as well as the initial commitment to liberalize (e.g. Rosendorff, 2005, Rosendorff and Milner, 2001, and Herzing, 2004).

(i) The role of a dispute settlement institution in trade agreements

Over time, a rules-based self enforcement regime that depends solely on the letter of the law and the benevolence of the membership can become quite challenging to manage, especially when the complexity of the trade agreement increases. The accession of new and more diverse countries, the inclusion of further industries, new areas of cooperation (such as environmental standards or intellectual property rights), and an increasing overlap with other international regimes will require more extensive and complicated rules and exceptions. A rise in complexity may result in more ambiguities and in more situations of private revelation of information.[128]

If such is the case, disagreements and trade disputes, sooner or later, are likely to occur. As was discussed in subsection 1.(b) above, asymmetrical information makes it easier for an injuring party to act opportunistically since the affected party has difficulties detecting a deviation and proving the size of the damage incurred. Contractual incompleteness – including the existence of ambiguities or loopholes – makes it harder for the affected party to point to a specific clause in the agreement in order to prove his suspicions. The contracting parties would need to negotiate the proper handling of unforeseen developments. Since this negotiation takes place *ex post facto* and if a wider renegotiation is to be avoided, these situations are usually difficult to solve without outside help. In short, contractual complexity may prove a challenge to the smooth and frictionless enforceability of a trade deal. This may motivate contracting parties to give the authority and independence to a formal dispute settlement body to deal with such issues within certain limits (Thompson and Snidal, 2005).

Subsection 1 above has demonstrated why formal institutions matter. It was shown that a formal organization may assume important roles in connection with dispute settlement, once realistic market imperfections, such as asymmetrical information or uncertainty over future events, are taken into consideration. The functions of such an organization may include monitoring and information dissemination, conciliation, arbitration and the calculation of damages, information gathering and adjudication of disputes. Taking the example of the WTO, Box 11 shows that the organization's dispute settlement mechanism (DSM) fulfils many of the institutional roles mentioned above. Box 11 shows that in discharging its functions, the DSM enhances enforceability,[129] but it does not have an impact on the enforcement capacity of the affected party.[130] Hence, "self-enforcement" remains a basic premise of virtually any trade agreement. Successful dispute resolution remains in the hands of the signatories, and ultimately depends on the willingness of the offending party to cooperate and/or in the enforcement capacity of the membership to punish the offending party.

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128 A more complex agreement can make it harder (and more costly) for signatories to anticipate and write down future contingencies, trade instruments and areas of disagreement. The further a trade agreement pervades into internal (as opposed to border) measures, the more difficult it may become for signatories to detect, prove and calculate violations of the agreement.

129 In assuming the role of an information disseminator, the DSM improves the chances of detecting a violation (observability). Taking up the role of an honest broker, information gatherer, adjudicator and arbitrator the DSM assists in assessing what actions really are sanctionable according to the terms of the agreement and helps to achieve a settlement (verifiability). Finally, when acting as an arbitrator and damage calculator, it ensures better quantifiability.

130 The DSB (and, more specifically, dispute settlement panels and the Appellate Body assisting it in carrying out its functions) provides Members with rulings on whether certain measures constitute violations of the WTO Agreement and recommends, if applicable, that the Members concerned bring these measures into conformity; ultimately, arbitrators pronounce on the size of countermeasures in the case of non-compliance. Yet, there is no equivalent to a national executive body that can put a verdict into effect. Hence, in the language used above, the institution cannot provide for "court-and-copper" enforcement; it can merely provide for more effective observability, verifiability and quantifiability.

Box 11: The WTO dispute settlement mechanism (DSM)

The DSM is the WTO's instrument for dispute resolution. In the first instance, it provides for consultations and settlement negotiations before resort can be had to the litigation process. In the next step, the complainant requests the establishment of a dispute settlement panel specifying the measure at issue and which provision of WTO law it violates. The parties submit arguments and evidence. In the light of the submissions by the parties, the panel determines the relevant facts of the case relating to the measure at issue. It has the right to gather information so as to ascertain the nature, operation and effects of the measure at issue. The panel also assesses the applicability of legal provisions invoked by the parties, interprets those provisions and applies them to the facts of the case in order to determine whether the challenged measure is inconsistent with the WTO Agreement. When a violation has occurred or trade benefits accruing under the WTO agreements have been nullified or impaired, the Member concerned is required to bring the measure at issue into conformity with WTO law. If it fails to fully comply within a reasonable period of time, and compensation is not forthcoming or not considered appropriate by the aggrieved party, it may impose, with prior approval by the DSB, countermeasures equivalent to the level of economic harm or loss in trade benefits caused. Finally, its role as information repository implies that the DSM monitors compliance and keeps official records about the disputes and their settlement. The DSU covers these functions in the following manner:

Central dispute settlement forum: The DSU applies to all covered agreements (Article II:2 of the WTO Agreement and Article 1 of the DSU). In addition, by virtue of Article 23 of the DSU, the WTO DSM has primacy over outside fora as far as the adjudication of disputes under the WTO agreements and the enforcement of WTO law is concerned.

Consultations: The DSM acts as an "honest broker" between disputing WTO Members. Article 4 of the DSU requires that consultations be held between the parties before litigation may be initiated. The aim of consultations is to reach a mutually acceptable settlement of the dispute. In addition, the DSM offers alternative forms of dispute resolution through conciliation, mediation and the good offices of the Director-General. The respective mandate is contained in Article 5 of the DSU. Article 5.1 of the DSU states that conciliation and mediation procedures are voluntary. In addition, Article 3.7 of the DSU stipulates that "[t]he aim of the dispute settlement mechanism is to secure a positive solution to a dispute". Indeed, on numerous occasions disputing parties have used the DSM to settle their disputes before a final ruling was adopted by the DSB (see Section D.3.(b)).

Information gathering and collection of evidence: Articles 11 of the DSU requires a panel to make an objective assessment of the matter before it, including of the facts of the case. Article 12 and the Working Procedures contained in Appendix 3 of the DSU specify the panel procedures to be followed (unless decided otherwise), including the deadlines for written submissions by parties. In order to obtain additional information or clarification, panels may at any time put questions to the parties and ask them for explanations. In addition, based on Article 13 of the DSU (entitled "Right to Seek Information"), dispute settlement panels "may seek information from any relevant source and may consult experts to obtain their opinion on certain aspects of the matter" (Article 13.2 of the DSU). It is important to note that the Appellate Body is barred from gathering new factual information by virtue of Article 17.6 of the DSU ("An appeal shall be limited to issues of law covered in the panel report and legal interpretations developed by the panel."). Also, the DSM may only deal with cases WTO Members decide to initiate before them. Panels do not have inquisitorial powers similar to *ex officio* prosecution by an attorney general or chief prosecutor. Moreover, in contrast to certain international tribunals, panels and the Appellate Body cannot give advisory opinions.

Adjudication: Article 11 of the DSU requires dispute settlement panels to assess objectively the matter before them as to the facts of the case and the applicability of, and conformity with, the relevant WTO covered agreements in relation to the measures in question.

Arbitration and quantification of damages: Articles 22.6 and 22.7 of the DSU authorize arbitrators to determine the level of economic harm and loss in trade benefits suffered by the aggrieved party and to determine, under Article 22.3 of the DSU, in which trade sectors or under which agreements other than those where the violation occurred retaliation is justified. Thus far, there have been 16 instances (in 7 separate disputes), where, following a request for authorization of countermeasures, arbitrators have determined damage awards.

Information dissemination, monitoring and surveillance: Article 2.2 of the DSU instructs the DSB to "inform the relevant WTO Councils and Committees of any developments in disputes related to provisions of the respective covered agreements". Article 21 of the DSU, entitled "Surveillance of Implementation of Recommendations and Rulings", obliges the DSB to monitor the implementation of adopted rulings.[131] This surveillance includes those cases where compensation has been provided or concessions or other obligations have been suspended but the recommendations to bring a measure into conformity with the covered agreements have not been implemented" (Article 22.8 of the DSU).

6. TRANSPARENCY

(a) Why is there a need for transparency?

The received theory of international trade cooperation has little to say about transparency in trade agreements because it assumes that trade partners have perfect information. This is equivalent to assuming that there are no (transaction) costs to acquiring or processing information. This is an understandable simplifying assumption given that the focus of the analysis is the inefficiency that arises from countries behaving strategically to alter the terms-of-trade to their advantage.

The section on institutions above discussed the problem posed by imperfect information. Imperfect information means that there is bound to be some cost involved in acquiring information and that, consequently, parties may not be fully informed or they may be differently informed, about matters that can have a significant economic impact on them. There are quite specific reasons for believing that the problem of imperfect information is acute in the case of trade agreements.

First, trade agreements involve governments making very detailed commitments on tariffs and other regulations that involve thousands of products. It would be difficult to keep track of all these commitments if they were not inscribed in schedules. In addition, the negotiations leading to these schedules often tend to be confidential. But once these negotiations are concluded, the information is a public good that can be made available without much cost by governments to those who can directly benefit from it - importers, exporters, etc., but who were not parties to the negotiations.

Second, parties are required to implement obligations made in the trade agreement. Given the reciprocal nature of liberalization, there is therefore a legitimate interest by a party to see to it that its partner is implementing its obligation. As the number of parties to an agreement, increases, it can quickly become very costly for one country to, on its own, monitor implementation by all its partners of their commitments across a range of measures and products. It may be more economical to require a country to notify all its trade partners about the status of its implementation of the obligations.

[131] Members may obtain, if necessary, a reasonable period of time for implementation. Moreover, compliance panels and the Appellate Body may be requested to establish whether the DSB rulings and recommendations have been fully implemented.

Third, the need to preserve or secure the gains from market access requires countries to make commitments on domestic regulations, involving among other things, standards, technical regulations, SPS measures and the like, that have non-trade objectives but whose application can have ramifications on trade. It may not always be easy to distinguish between well-intentioned regulations that only have an unintended adverse effect on imports from measures that are intended as hidden protectionism. As noted in the discussion on enforcement above, the ambiguity inherent in such situations can sometimes lead to dispute settlement. Transparency of the regulations and the regulatory process may assist in removing this ambiguity and therefore avoid costly dispute settlement proceedings in situations where none is called for.

There is also another aspect to transparency that has to do with the institution (organization) that, because of transaction costs and imperfect information, has been established to help the Members better implement the rules of the trade agreement. There are two aspects to this institutional transparency. One is internal transparency, which involves making the decision-making process as open as possible to the membership. The Members of the institution need not have the same access to financial and human resources. While it is not possible to fully correct for such differences, there are some which have a public good aspect, that with little cost can be disseminated with a significant improvement in the quality of the decision-making process. The second aspect is external transparency, which involves the institution's openness to the public.

Transparency helps achieve two objectives. The first is improved compliance by the parties to the commitments they have made under the trade agreement. Shining a spotlight on the parties keep them on the straight and narrow. Second, going beyond the parties to the agreement, transparency should help private economic agents better understand the environment in which they operate and enable them to make better decisions. Markets will function more efficiently when economic agents have better information.

(b) Transparency in the WTO

Provisions on transparency are spread across the range of WTO Agreements. While the transparency provision in a particular WTO Agreement may be concerned only with the narrow range of measures covered under that Agreement, such as subsidies or SPS regulations, the cumulative effect of these provisions is to diminish the opaqueness of a Member's trade regime and trade policymaking process. There could be a number of ways of classifying these transparency provisions. This sections closely follows Wolfe (2003) who groups the transparency provisions into: a) tariff and services schedules which codify Members' commitments; b) the Trade Policy Review Mechanism; c) publication and notification; d) internal transparency by which is meant transparency of the institution to its Members (particularly those with limited resources or with no presence in Geneva) and e) external transparency to civil society.[132] Although Wolfe (2003) does not speak about surveillance, it is a function that is explicitly provided for in a number of WTO Agreements. Thus, the meaning of surveillance, how it is linked to transparency and how it may help reduce the incidence of disputes is also discussed.

(i) Schedules of concessions

Although not explicitly identified as a mechanism for transparency, the schedules of concessions and schedules of specific commitments by WTO Members are probably some of the most valuable. The schedules, which frequently run into hundreds or even thousands of pages, codify in great detail the obligation of each WTO Member with respect to import duties and limitations on trade in services that are to be applied to other Members.

In GATT 1994, the relevant article is Article II (Schedules of Concessions) which comes immediately after the MFN clause. For non-agricultural goods, the schedule usually consists of tariff bindings but in the

[132] In his classification, Wolfe (2003) also includes independence from the executive branch of government.

case of agricultural products, the schedule also includes tariff rate quotas, limits on export subsidies and domestic support. The schedules are considered an integral part of the GATT.

Article XX (Schedules of Specific Commitments) is the corresponding provision in the case of the GATS. The schedules identify the service sectors to which a Member will apply the market access and national treatment obligations of the GATS and any exceptions from those obligations it wishes to maintain. The commitments and limitations are listed with respect to the four modes of supply – cross-border supply; consumption abroad; commercial presence; and presence of natural persons. The schedules are considered an integral part of the GATS.

(ii) Trade Policy Review Mechanism

The Trade Policy Review Mechanism (TPRM) was established under Annex 3 of the Marrakech Agreement. Its purpose is: "to contribute to improved adherence by all Members to rules, disciplines and commitments made under the Multilateral Trade Agreements and, where applicable, the Plurilateral Trade Agreements, and hence to the smoother functioning of the multilateral trading system, by achieving greater transparency in, and understanding of, the trade policies and practices of Members. Accordingly, the review mechanism enables the regular collective appreciation and evaluation of the full range of individual Members' trade policies and practices and their impact on the functioning of the multilateral trading system. It is not, however, intended to serve as a basis for the enforcement of specific obligations under the Agreements or for dispute settlement procedures, or to impose new policy commitments on Members." This objective is to be realized through regular reviews of a Member's trade policies and practices. Before this, a peer review mechanism of a Member's trade policy had been provisionally established in 1988.

The frequency of a review depends on a Member's share of world trade. The four biggest traders are to undergo a review every two years. The next 16 are to be reviewed every four years. The rest of the Membership is to go through a review every six years, with possibly a longer period for LDCs. Each review is conducted on the basis of a report by the Secretariat and a statement by the Member concerned. Any Member is allowed to comment on the report, which stresses the transparency aspect of the above objective, or the policy statement, thereby providing an opportunity for an exchange of views. Each report is subsequently published and made available to the general public.

Reviews are conducted by the WTO's Trade Policy Review Body (TPRB). For each review of a Member, two documents are prepared. One is a policy statement by the Member under review. The second is a detailed report written by the WTO Secretariat on its own responsibility. The Secretariat's report consists of detailed chapters examining the trade policies and practices of the Member and describing trade policymaking institutions and the macroeconomic situation. The Secretariat report and the Member's policy statement are published after the review meeting, along with the minutes of the meeting and the text of the TPRB Chairperson's concluding remarks delivered at the conclusion of the meeting.

The review of Members' policies, practices and measures under the TPRM throws light on how policies and measures not covered by WTO rules may nonetheless have an important bearing on the international movement of goods, services, capital and labour, and can have effects equivalent to or that vitiate measures subject to existing WTO disciplines. The review of broad macroeconomic and structural policies attempt to place trade and trade-related policies in their broader policy setting, thereby contributing to a better assessment of the coherence of these policies in achieving their objectives.

The transparency that is achieved in the TPRM process covers four key elements of economic policymaking. First, a clear description of the nature of policies and measures. Second, their rationale or objectives. Third, the costs incurred in terms of expenditures or taxes forgone in pursuit of these policies and measures. And lastly, an economic evaluation of the effectiveness of policies and measures (relative to viable alternatives) in achieving their objectives. Accordingly, the TPRM enables the regular collective appreciation and economic evaluation of a full range of individual Members' trade policies and practices,

their consistency with the broad principles of non-discrimination and predictability that underlie the WTO, and their impact on the functioning of the multilateral trading system.

(iii) Publication and notification obligations

Article X of the GATT requires Members to "publish promptly in such a manner as to enable governments and traders to become acquainted with them" all information related to the administration of trade regulations. The essential idea behind the publication obligation is that other WTO Members that are likely to be affected by governmental measures should have a reasonable opportunity to acquire information about such measures and either to adjust their activities or to seek modification of such measures.[133]

Notification provisions are, in terms of count, the most commonly found transparency mechanism in the WTO Agreements. Notifications are required to inform other Members about the enactment of legislation, or the adoption of new measures, or the progress made in the implementation of commitments. A number of Agreements also contain obligations to publish information on a relevant measure or establish enquiry points so that members know where they can obtain the relevant information.

(iv) Institutional transparency (internal and external transparency)

Internal and external transparency have less to do about clarification of the provisions in multilateral agreements as with laying bare the process of decision-making in the institution or organization itself. The objective of internal transparency is to make decision-making in the WTO transparent and genuinely inclusive. It includes the outreach by the WTO to the smallest and poorest WTO Members, particularly to those without WTO missions in Geneva (non-resident delegations).

External transparency refers to the WTO's efforts to engage with civil society groups and the public at large. Much of this involves making available official WTO documents, reports, submissions by WTO Members and trade-related statistics. Other activities related to external transparency involve giving civil society groups access to relevant WTO meetings, including the Ministerial Conferences, and the holding of public forums to better explain the institution and WTO Agreements.

Section D provides a detailed account of how the GATT/WTO has responded to the challenge of ensuring internal and external transparency in its dealings with members and with the public.

(v) Surveillance

While transparency is an obligation by the Members to ensure that the trade measures they take are clear and easily understood, surveillance goes beyond that. It implies keeping watch over the compliance by Members to the obligations they have incurred under the WTO Agreements. It is almost always an activity which is vested in the institution (and its bodies) rather than in the Members.

A number of WTO Agreements contain explicit provisions on surveillance. The Dispute Settlement Understanding (Article 21:6) requires the Dispute Settlement Body to keep under surveillance the implementation of adopted recommendations or rulings. Article 26 of the SCM Agreement requires the Committee on Subsidies and Countervailing Measures to review Members' subsidies notifications at special sessions held every third year. The surveillance function assigned by Article 13 of the Safeguards Agreement to the Committee on Safeguards appears to have a wider ambit. But those functions include monitoring the implementation of the agreement, examining and monitoring the phase-out of VERs (for more of VERs, see Section D of this Report) and receiving and reviewing all safeguard notifications.

But even though other WTO Agreements do not contain an explicit provision on surveillance, almost all of them establish bodies that perform essentially many of the same functions described above. Article 68

[133] See Appellate Body Report on *US-Underwear*, p. 21.

of the TRIPS Agreement mandates the TRIPS Council to monitor the operation of the TRIPS Agreement and in particular, Members' compliance with their obligations under that Agreement. The Agreement on Agriculture (under Article 17) requires the Committee on Agriculture to monitor the progress in the implementation of commitments negotiated under the Uruguay Round reform programme. Any Member may bring to the attention of the Committee on Agriculture any measure which it considers ought to have been notified by another Member. The Committee on Technical Barriers to Trade (under Article 15) is to review annually the implementation and operation of the TBT Agreement. The Committee on Trade-Related Investment Measures (under Article 7) is to monitor the operation and implementation of the TRIMS Agreement. The Committee on Antidumping provides semi-annual reports of anti-dumping actions taken by WTO Members within the preceding six months.

Surveillance in the WTO, takes place principally through the various committees or WTO bodies that have been established by the WTO Agreements. The raw material of this surveillance comes from the notifications, complaints and requests for consultations by Members as well as reports prepared by the Secretariat. Thus there is an important link between the observance of transparency by Members, their ability to provide timely and accurate notifications to various WTO organs and the quality of the surveillance function of the WTO.

The existence of the Trade Policy Review Mechanism, in particular, has occasioned comparisons with the surveillance activity conducted by the International Monetary Fund. There are similarities but also important differences in the surveillance performed by the IMF and the surveillance in the WTO. In terms of differences, there appears to be two essential ones. First, the IMF has been given an explicit legal mandate to conduct surveillance over exchange rate arrangements in its Articles of Agreement (Article IV, section 3 of the Articles of Agreement). This surveillance has two interrelated aspects: surveillance over the entire international monetary system and, to fulfil that function, surveillance "over the exchange rate policies of members". While specific bodies in the WTO may be tasked with surveillance (such as the Dispute Settlement Body, or the Committee on Subsidies and Countervailing Measures, or the Committee on Safeguards), there is no surveillance provision in the WTO Agreements that has the same overarching scope as in Article IV of the IMF Articles of Agreement.

Second, the objective of Fund surveillance is to produce "specific principles for the guidance of all members" with respect to their exchange rate policies. All Fund Article IV staff reports provide a set of policy recommendations that are submitted to the IMF Board for discussion. The Board's views are subsequently summarized and transmitted to the country's authorities, clearly with a view to influence policy. In the case of the WTO, there are quite explicit restrictions on what could be done with the product of transparency. As noted above, the Trade Policy Review Mechanism explicitly rules out the TPRM as a "basis for the enforcement of specific obligations ... or for dispute settlement procedures, or to impose new policy commitments on Members."

But this is not to say that the surveillance conducted by WTO bodies together with the observance of the transparency provisions of WTO Agreements by Members does not have the same potent effect. The transparency required of the measures that Members take, and in general of their trade regime, and the knowledge that the institution stands on watchful guard for possible violations create a powerful incentive for Members to abide by their commitments. That increases the level of confidence in the value of commitments made by the Members.

It also means there are less wilful violations of the Agreements and hence less frequent recourse to dispute settlement proceedings. Unnecessarily frequent disputes and recourse to dispute settlement are costly to WTO Members and to the institution because they require expenditures on resources and they can damage the reputation of the institution. To the extent that WTO surveillance reduces the frequency of such disputes among Members, it performs a valuable function.

(c) Transparency provisions in RTAs

Transparency provisions in RTAs appear to resemble many of the elements found in the multilateral trading system. Thus, bilateral and regional trade agreements typically contain schedules of concessions, as well as notification and publication obligations on a wide range of trade and regulatory measures (see Section D for a more extended discussion of transparency in RTAs). The one big difference may be the absence of a peer review mechanism like the Trade Policy Review Mechanism of the WTO. Moreover, given that membership in these agreements is considerably smaller than in the WTO, there is less of a requirement for internal transparency. Except for the largest regional integration agreements, such as the EC or NAFTA, there appears to be no equivalent effort to engage civil society groups and the general public by providing access to official documents or events.

7. CONCLUSIONS

This chapter began by asking two questions. What are the rules that make up a trade agreement? Why are institutions often established in addition to the rules?

In answer to the first question, five areas of rule-making were identified. Rules on reciprocal liberalization allow the parties to the trade agreement mutually to reduce levels of protection below that of the prisoners' dilemma outcome. Rules on anti-circumvention, such as national treatment, prevent parties from using domestic policy instruments to erode the value of trade concessions granted to partners. Rules on contingent measures allow parties to the agreement to escape temporarily from their liberalization commitments when domestic producers suffer injury. They trade off short-term protectionism in order to lock in deeper levels of liberalization. Enforcement deters defection from the terms of the agreement. Rules on transparency reduce the cost of acquiring information about trade partners' measures and policies so as to better to assess compliance with the terms of the agreement.

In answer to the second question, institutions are established because of the presence of transaction costs and information asymmetries. An institution is created because trade agreements may be incomplete contracts and because of a demand for a conciliator or honest broker. The institution is often vested with substantial authority and given important responsibilities. Among these important responsibilities are facilitating negotiations, disseminating information and settling international trade disputes.

The discussion in this chapter of the institution and the rules in trade agreements has been primarily of a conceptual or theoretical nature. But it provides an useful lens for assessing the contributions that can be made by trade rules and institutions. It shall be left to the last part of this Report – Section D – to narrate how these rules and the institution itself have evolved in the multilateral trading system, to identify the principal achievements of the system and the challenges that have emerged along the way.

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