
Monitoring International Trade Policy

A New Agenda for Reviving the Doha Round

Centre for Economic Policy Research (CEPR)

Centre for Economic Policy Research
2nd Floor
53-56 Great Sutton Street
London EC1V 0DG
UK

Tel: +44 (0)20 7183 8801
Fax: +44 (0)20 7183 8820
Email: cepr@cepr.org
Website: www.cepr.org

Kiel Institute for the World Economy

Düsternbrooker Weg 120
24105 Kiel
Germany

Tel: +49 431 8814 1
Fax: +49 431 8585 3
Email: info@ifw-kiel.de
Website: www.uni-kiel.de/ifw

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A New Agenda for Reviving the Doha Round

Bruce Blonigen

University of Oregon

Alan V. Deardorff

University of Michigan

Philippa Dee

Australian National University

Christopher Findlay

University of Adelaide

Patrick A. Messerlin

Sciences Po

Robert M. Stern

University of Michigan

John Whalley

University of Western Ontario



This publication is dedicated to Bijit Bora (WTO) who died in October, 2006, and to Riccardo Faini (University of Rome Tor Vergata & CEPR, London) who died in January, 2007.

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About the Authors

Bruce Blonigen is the Knight Professor of Social Science in the Economics Department of the University of Oregon and Research Associate with NBER. Worked during doctoral as an economist at the USITC, Research Division of the Office of Economics. He teaches courses in international economics, industrial organization, and statistical methods at both graduate and undergraduate levels. He won the University of Oregon's 2003 Ersted Award for Distinguished Teaching, the University's highest award for teaching excellence. His research focuses on empirically examining international trade issues from a microeconomic and political economy perspective, especially with respect to multinational corporations and antidumping policies. In this connection he maintains a website that shares information and data on U.S. antidumping activity. His work on multinational corporations and foreign direct investment (FDI) has explored the determinants of FDI activity in the United States, as well as impacts of inward FDI on the U.S. economy; in particular on wages and political pressure for trade protection. He serves as a Co-Editor for the *Journal of International Economics* and the *Journal of International Business Studies*, as well as being on the editorial boards of the *American Economic Review*, *Canadian Journal of Economics*, *Review of International Economics*, and the *North American Journal of Economics and Finance*.

Alan V. Deardorff is the John W. Sweetland Professor of International Economics and Professor of Economics and Public Policy at the University of Michigan. He received his Economics Ph.D.(1971 from Cornell University) and has been on the faculty at the University of Michigan since 1970 (he chaired the Department of Economics from 1991 to 1995). He has served as a consultant to numerous government and international agencies, (e. g. State Dept, Treasury, World Bank. OECD and UNCTAD). He is currently on the editorial boards of the *Journal of International Economic Law*, the *North American Journal of Economics and Finance*, and *The World Economy*. He is co-author, with Robert M. Stern, of *The Michigan Model of World Production and Trade and Measurement of NTBs*. He has published articles on international trade theory and trade policy, in particular re. the theory of comparative advantage and the Heckscher-Ohlin and other models that explain the patterns and effects of international trade. His work on trade policy covers anti-dumping laws, safeguards clauses of the GATT/WTO, arguments for/against extending intellectual property protection to developing countries, and most recently the WTO Doha Round of Multilateral Trade Negotiations. His work with Bob Stern focused on a model of production, trade, and employment in 34 major countries of the world. Together with Drusilla K. Brown they also developed a series of models to evaluate the sectoral employment implications of various regional trading arrangements in North America, the Western Hemisphere, Asia, and Europe.

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Philippa Dee is currently Visiting Fellow at the Asia-Pacific School of Economics and Government at the Australian National University. There she is pursuing research on the effects of liberalising barriers to trade in services in a number of developing countries. She was previously Assistant Commissioner at the Australian Productivity Commission. There she worked on a wide range of economic policy issues, from evaluating Australia's greenhouse gas policies, R&D policies and National Competition Policy, to evaluating the effects of multilateral Uruguay and APEC trade liberalisation. She also contributed to seminal collaborative research with the Australian National University in measuring and evaluating barriers to services trade and their accompanying domestic regulatory regimes. She has been involved in numerous World Bank projects covering such issues. She has held a previous academic position at Australian National University and a research position at the Kiel Institute for the World Economy. She was educated at Victoria and Canterbury Universities in New Zealand and at Simon Fraser University in Canada.

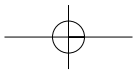
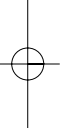
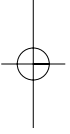
Christopher Findlay assumed, in November 2005, the position of Professor of Economics at the University of Adelaide. Prior to that he was Professor of Economics in the Asia Pacific School of Economics and Government at the Australian National University. Australia's economic relations with Asia are the theme of his research. A special interest is the reform and industrialisation of the Chinese economy. Professor Findlay has been especially involved in research on the textiles, steel and air transport industries in East Asia and on the implications of developments in those industries for Australia. Likewise he has been extensively involved in trade and protection issues within the APEC region. Professor Findlay was a principal researcher in a major research program on impediments to services trade and investment. Professor Findlay has a PhD and MEd from the ANU and an Honours degree in economics from the University of Adelaide.

Patrick A. Messerlin is Professor of Economics at the Institut d'Etudes Politiques de Paris (known as Sciences Po), and Director of the Groupe d'Economie Mondiale de Sciences Po (GEM), an independent think tank seeking to promote a "culture of evaluation in a global world" (see <http://gem.sciences-po.fr>). In 2002-2005, he was co-chairman with Dr Ernesto Zedillo, Former President of Mexico, Director of the Yale Center for the Study on Globalization, of the Task Force on Trade in the UN Millennium Project launched by Secretary General Kofi Annan. In 2001-2002, he was special advisor to Micheal Moore, WTO Director General. He published numerous books and more than a hundred of papers on trade theory and policy, the most recent being *Measuring the Costs of Protection in Europe: European Commercial Policy in the 2000s*, (IIE, Washington, 2001), and *Europe after the "No" Votes*, (Institute of Economic Affairs, 2000). The UN Millennium Project Task Force released its Report on Trade for Development in May 2005 (available on <http://gem.sciences-po.fr> or <http://www.millenniumproject.org>). In November 2005, he delivered the 35th Wincott Lecture in London, published by the Institute of Economic Affairs.

About the Authors vii

Robert M. Stern is Professor Emeritus of Economics and Public Policy at the University of Michigan, and obtained his Ph.D. in Economics from Columbia University in 1958), was a Fulbright scholar in the Netherlands in 1958-59, taught 2 years at Columbia U. and joined the faculty at the University of Michigan. in 1961. He has actively contributed to international economic research/policy for more than four decades, covering international commodity issues, determinants of comparative advantage, price behavior in international trade, balance-of-payments policies, computer modeling of international trade/trade policies, trade and labor standards, and services liberalization. He has consulted for U.S. Government agencies and international organizations/foreign government agencies. He has collaborated with Alan Deardorff) since the early 1970s in developing the Michigan Model of World Production and Trade. This computer-based model has been used to study policy issues such as the effects of the GATT/WTO multilateral trade negotiations, changes in the structure of protection, trade and employment, and the effects of regional trading arrangements. He is currently working on the computational modeling and analysis of regional trading blocs, issues in U.S.-Japan international economic relations, the political economy of U.S. trade policy, issues in the design of the WTO and the conduct of multilateral trade negotiations.

John Whalley is the William G. Davies Professor of International Trade and Co-Director at the Centre for the Study of Economic Relations in the Department of Economics, University of Western Ontario. He received his M.A at the University of Essex and his Ph.D from Yale in 1973, assessing the April 1973 tax changes in the UK. He is a research associate of the NBER, Cambridge; Coordinator, Global Economy Group, CESifo, U. of Munich. He has written extensively on world trade, WTO and globalization issues and dealt widely with measures impacting on trade in textiles, steel and agriculture. He was formally joint managing editor of *The World Economy* (with David Greenaway) and held positions at the IIE, the University of Warwick and advised the World Bank and the OECD. Recently he was a guest professor at the University of Beijing. His current interests cover globalization, the WTO and the world trading system, together with the new protectionism in trade with textiles/clothing, steel and agriculture. This implies also deepened interest in development strategies in the third world and trade liberalization in developing countries. In many of these areas applications of general equilibrium techniques assist in the policy analysis, be it with respect to public finance, taxation and trade barriers. In some of his most recent works issues deal with China (trade liberalization and Chinese state owned industries), services and regional agreements have played a important role.



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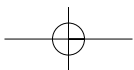
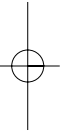
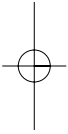
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Foreword

This report analyses the problems of the current Doha Round and discusses an agenda for reviving the Round. The authors identify a number of important long-run trends that the WTO must simply come to grips with before meaningful progress can be made. The Kiel Institute for the World Economy and CEPR are delighted to provide this vehicle through which some of the most prestigious scholars in trade policy present their analysis to policy-makers, academics and the informed public.

Richard Baldwin
CEPR Policy Director

29 May 2008



Introduction and Summary

Bruce Blonigen, University of Oregon

The trend is obvious. Recent rounds of the General Agreement on Tariffs and Trade (GATT) have become increasingly lengthy. Initial rounds after the Second World War took a matter of weeks or months. In contrast, the most recently completed negotiations – the Uruguay Round – took more than seven years to complete. The current Doha Round, which began in late 2001, has clearly stagnated – and even if completed, it is likely to achieve very little.

While the trend is obvious, the main drivers of this trend towards ever longer negotiating rounds are far from obvious, though there are a number of suspects:

- First, the number of participants has grown substantially, from 20-30 participants in the early rounds to well over 100. But until the World Trade Organisation's (WTO) ministerial conference in Cancún in September 2003, when Brazil, China, India and other developing countries formed a negotiating coalition (the G20), the active lead negotiators had always consisted of only the United States, the main European nations and a few other developed countries.
- A second possible cause is the increasing complexity of issues now open for negotiations. After so many successful early rounds, it may be that all that is left are the distorting measures in trade in goods that countries have tried hardest to protect from the very beginning. In other words, the 'low-hanging fruit' are gone and the 'high-hanging fruit' are indeed very difficult to reach.
- In a similar vein, negotiations have begun to reach into completely new areas, which are much more complex. An example is trade in services, for which even developed countries have great difficulty in measuring trade volumes, much less trade distortions for these products from government policies and regulations. Other obvious examples are negotiations over 'trade-related matters', such as intellectual property protection.
- Another possible cause is political. Countries may simply have less political will to conduct successful negotiations than they did in the past. The end of the Cold War may have made multilateral agreements less crucial for the developed market economies, the main drivers of

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these rounds. This, or other forces, may have made the main players more regionally oriented, turning their efforts towards regional integration rather than multilateral integration.

While much of the current attention is on the month-to-month developments in the Doha Round, this inaugural volume of an annual series from the Trade Policy Monitoring Centre takes a longer-term view of the process to get a better understanding of what will have to happen for current or future rounds to make significant progress. We are extremely fortunate to have some of the most prestigious scholars in trade policy providing this analysis.

In Chapter 1, Patrick Messerlin examines the most salient long-run issues for the developed countries, traditionally the main drivers of the trade negotiations.

A significant portion of Messerlin's analysis examines the declining ability of the big developed countries to lead current and future negotiations. His argument is not the common one that the United States is a declining world power and thus unable to impose its will on others. Rather he points out that the length of the rounds now extends past these main countries' political cycles. If rounds are not completed in one political cycle, then momentum is often lost as a new political regime comes into place. Likewise, ever-thinner majorities for the ruling parties of these countries can undermine their will to lead the negotiations.

With this issue in mind, Messerlin offers a number of reforms that can help the WTO to 'flexipline' the negotiations – that is, to provide enough flexibility with easy disciplining rules to get shorter successful rounds. A main recommendation is to limit the objectives of each round and focus on the core goal of increasing market access. His recommended reforms also include much wider use of simple rules, such as the 'Swiss formula' for reducing trade protection, and considerable loosening of the 'single undertaking' principle.

In Chapter 2, Alan Deardorff and Robert Stern examine the trade negotiation issues most salient to the developing countries. Such a focus on the developing world's perspective has become crucially important with the Doha Round labelled the 'development round' and the rising prominence of developing countries such as Brazil, China and India in recent ministerial conferences.

A main message that comes from the Deardorff and Stern analysis is that the developing countries are not served very well if the implicit (or explicit) understanding is that they do not have to offer 'concessions' in this round of negotiations. As economic theory and empirical evidence suggest, developing countries gain from liberalising their own trade. Their analysis also points out the varied ways in which historical preferences given to special groups of developing countries by the developed world are likely to be one factor in developing countries' enthusiasm for multilateral liberalisation.

Both of the first two chapters provide a number of new and interesting perspectives on the role of preferential trade agreements (PTAs) in the multilateral negotiating process. Messerlin's chapter argues that PTA activity has not been increasing by nearly as much as is usually supposed. In particular, the PTA activity by larger countries/regions such as the European Union and the United States has been with much smaller countries, and these PTAs appear to be about preferential treatment rather than market access.

Deardorff and Stern's chapter reviews the ways in which PTAs could be benefi-

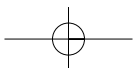
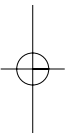
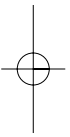
cial or harmful and provides some empirical evidence from previous work that recent PTAs have modestly increased global welfare. But they also have specific recommendations about how PTAs can best improve welfare by 'approximating' multilateral trade liberalisations as closely as possible.

The final chapter by Philippa Dee and Christopher Findlay provides a more focused analysis of services, an issue that will be increasingly important in trade negotiations. Dee and Findlay first provide a cogent analysis of how and why service sectors can be quite different economically than traditional manufacturing industries and why this then leads to potentially different treatment in trade liberalisation negotiations.

Their main point is that for many service sectors, domestic liberalisation is required before foreign firm access (that is, national treatment) would be useful in achieving efficient market outcomes. In other words, one cannot put the cart before the horse. Because of this, they argue that services may not be the area to lead concessions and ultimately a successful round of liberalisation; rather, the WTO can provide an important framework for furthering domestic reform by its members.

In summary, the chapters in this volume have identified a number of important long-run trends that the WTO and its members must simply come to grips with before meaningful progress can be made:

- Rounds need to be shorter, and this is likely to be achieved by focusing on core principles such as market access and the wider application of simple rules.
- New issues such as services are much more complicated than simple trade liberalisation of manufacturing sectors and are likely to require prior domestic changes before trade liberalisation is beneficial.
- Successful outcomes for developing countries come not only from trade liberalisation concessions made by the developed world but also by the developing countries themselves.
- PTAs should be viewed with caution, though not seen as necessarily evil. But if the WTO and its members cannot solve the key issues, there is likely to be much more activity in PTAs and the WTO will be in danger of becoming obsolete in furthering trade liberalisation.



1 Reviving the Doha Round: The Agenda for the Developed Countries

Patrick Messerlin, Groupe d'Economie Mondiale, Sciences Po¹

It is generally perceived that the main source of the repeated difficulties - and potentially indefinite suspension - of the Doha Round of multilateral trade negotiations is a lack of political leadership. This observation tends to trigger two opposite reactions:

- The first is that this situation will be transitory: sooner or later, political leadership will return to the World Trade Organisation (WTO), the international body that oversees the multilateral trading system.
- The alternative reaction is that political leadership is unlikely to return any time soon and that it condemns the multilateral trading system to a long period of stagnation. Proponents of this view argue that the likely consequence is that countries will turn to the substitute of preferential trade agreements (PTAs) or 'bilaterals': indeed, they claim, the shift to PTAs began a decade ago and it is accelerating.

Section 1 argues that the first view is a dangerous illusion. The current lack of leadership in the WTO is a systemic problem that will persist for many years, perhaps decades, to come. Of course, visionary and courageous leaders could emerge at some point in the future, but there are many reasons to believe that such a hope is unwarranted and almost irrational.

Section 2 shows that the second view grossly overestimates and misinterprets the increase in numbers of PTAs. It also argues that the European Commission's 2006 proposal for more European Union (EU) bilaterals represents a serious danger to the multilateral trading system, potentially launching a race to establish more PTAs by the larger WTO members (which have so far been 'marginal' players in this game, contrary to what is widely believed).

How to cope with a systemic lack of political leadership while minimising the risks created by PTAs? Section 3 argues that the most commonly proposed solution - better monitoring of PTAs by the WTO - is not enough. The efficiency of the WTO negotiating process needs to be improved, and doing this will make bilaterals less attractive.

Section 3 highlights six sources of greater efficiency, which have one common

¹ The author would like to thank Bruce Blonigen, Bernhard Speyer, Tony Miller, Richard Baldwin and André Sapir for their very constructive comments.

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goal: shorter rounds of trade negotiations. These reforms aim at 'flexiplining' the WTO negotiating process, disciplining it with the first two reforms and making it more flexible with the remaining four:

- By focusing on the core WTO business of market access.
- By relying on formulas for negotiating market access in goods.
- By reassessing the value of binding tariffs.
- By relying on 'plurilaterals' (groups of willing countries) for negotiating market access in services.
- By reinterpreting the 'single undertaking' principle, currently understood to require all WTO members to sign up to all new agreements.
- By mellowing the bilaterals by more WTO-friendly 'rules of origin', the criteria used to define where a product was made.

As these reforms reinforce each other, each of them can be used more 'gently' than if it were implemented alone. The concluding section looks at the countries that could promote such changes, and underlines the absolutely crucial role of domestic support for these endeavours.

1 **Domestic politics and leadership in the WTO**

The five first rounds of multilateral trade negotiations lasted fewer than 18 months each. The next two – the Kennedy Round in the 1960s and the Tokyo Round in the 1970s – took fewer than six years. But the last one – the Uruguay Round – was eight years long assuming it started at the Punta del Este meeting in 1986, but more accurately, 12 years taking account of the failed start in 1982.

The growing length of trade rounds is putting pressure on politicians in the developed countries for two key reasons:

- They abide by constitutional rules that are unchanged since the end of the Second World War (and sometimes much before).
- They are operating in democracies that are delivering increasingly thin majorities, eroding the consensus in favour of freer trade that prevailed until the 1990s.

National constitutional rules and multilateral trade negotiations

Constitutional rules in key developed countries are often biased against further trade liberalisation. Some of these rules have a long-term impact.

In the United States, for example, the president has a four-year mandate that can be extended only once. He/she thus has a maximum of eight years to launch and conclude multilateral trade negotiations, with a presidential campaign in the middle of the negotiations. As the president needs a year or so to convince Congress (which has the key power of ratifying trade agreements) to grant 'fast track' authority for a full mandate of negotiations, his/her window of opportunity is reduced to roughly six years.

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This time constraint played no role in trade negotiations up to and including the Tokyo Round since all these rounds were concluded in fewer than six years. But it began to generate concerns during the Uruguay Round, and it has become a major constraint on progress in the Doha Round.²

Other constitutional rules have a more specific impact. For example, the US constitution amplifies the strength of the country's agricultural interests by giving two senatorial seats to every US state. There are 23 US states with sales of farm products whose share of 'gross state product' is larger than the share of farm products in the entire US economy are represented by 46 senators. This is a huge over-representation and is likely to bias US policy-making against trade liberalisation in agriculture.³

This constraint did not play any role until the Uruguay Round, first because liberalisation in agriculture was not on the agenda before the Uruguay Round, then because the Uruguay Round did not generate substantial tariff or subsidy cuts in agriculture. But as long as farm tariff and subsidy cuts are major issues of negotiations in the current and future rounds, it is likely to play a crucial role.

The EU's constitutional arrangements are a strong handicap to significant leadership in multilateral trade negotiations. The EU is a collective decision-maker, with 'majority rule' as the most frequent decision process for trade in goods. But majority rule has a severe limitation: every time a trade-related topic is of critical importance to an individual EU member state, it can exert an indirect veto by threatening to use its veto rights on other issues that are subject to consensus rather than majority rule (internal taxation, for example).

As EU enlargements are likely to expand the range of trade issues of critical importance (it would be surprising if new member states did not bring their own critical trade agenda), they are likely to reduce the EU's capacity to take initiatives in trade negotiations. At the very least, adding new member states will slow down the process, so that time can be found to strike a deal on intra-EU trade-offs capable of unlocking EU trade strategy.

Increasingly thin majorities

Standard economic analysis shows that trade is beneficial for a country as a whole but that it is likely to be detrimental to certain groups of people within the country. It thus provides an explanation for an apparent paradox: the multi-decade push towards freer trade and the persistently re-emerging opposition to such liberalisation.

2 President Truman was able to conclude three trade rounds, and President Eisenhower two. The Kennedy Round was the first to be launched by a president, but it was concluded by his successor (President Johnson) who was Vice-President during the Kennedy Presidency. The Tokyo Round was the first to involve two presidents from different parties (President Ford, a Republican, and President Carter, a Democrat) while the Uruguay Round lasted for three presidencies (Presidents Reagan and Bush senior, two Republicans, and President Clinton, a Democrat).

3 These 23 states do not include eight states (California, Texas, Illinois, Georgia, Florida, Ohio, Michigan and Pennsylvania) with the largest farm output in the country, but which have farm shares of gross state product that are smaller than the share in the entire US economy. The EU exhibits a relatively similar feature (Messerlin 2007).

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But it also raises another paradox that has attracted surprisingly little attention. At the beginning of the process of trade liberalisation by the developed countries after the Second World War – from the 1950s to the 1970s – import-competing vested interests were large compared with export lobbies, because export sectors are initially embryonic and import-competing sectors cover a vast range of products. But despite the unfavourable balance of domestic forces during these years, governments were able to generate momentum in favour of trade liberalisation.⁴

Nowadays, in sharp contrast, developed countries are characterised by smaller import-competing sectors, often routinely adjusting to foreign competitors, and by wider and strong export interests. As a result, a smoother ride towards freer trade might be expected. But in reality, further trade liberalisation is making slow progress in most developed countries.

Why has there been such a slowing down? Three potential culprits are:

- A lack of interest in the export sectors and the wider business community in the developed countries. But if this community has been slow to join the debate of the Doha Round (an attitude that is easy to understand when confronted with the confused debates of the WTO negotiators), it has been very active recently (International Chamber of Commerce 2007; *BusinessEurope* 2007; National Association of Manufacturers 2007).
- The people of the developed countries, and their loss of appetite for freer trade. But recent polls show that, on the contrary, there is strong public support for international trade in both the EU and the United States – an average of 70% of public opinion (German Marshall Fund 2006).
- Vested interests opposed to freer trade, which are tiny but strong and well organised (Baldwin 2006). But strong and tiny lobbies are not a new story in trade matters. The fewer than 30,000 US cotton farms and 25,000 EU banana farms echo the candlestick makers so eloquently described by Bastiat (1845) over 150 years ago.

The erosion of the consensus in favour of freer trade that has occurred during the two last decades thus requires a better explanation. A more convincing candidate is the increasingly thin governing majorities in the major developed countries since the late 1980s. Thinner majorities give the strong and tiny vested interests a power increasingly out of proportion with their real importance, suffocating the huge support for freer trade among the people and business.

Charts 1.1 to 1.5 illustrate the evolution of governing majorities in the four largest founding members of the General Agreement on Tariffs and Trade (GATT) since the 1950s. They focus on majority margins (irrespective of which party is the winner) in elections that are most important from a trade perspective.

4 Introducing 'political' weights for sectors that would counterbalance their size effect (as done in the research literature) 'solves' the problem, but without explaining the nature and the emergence of such political factors.

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Figure 1.1 Increasingly thin majorities: US presidential elections

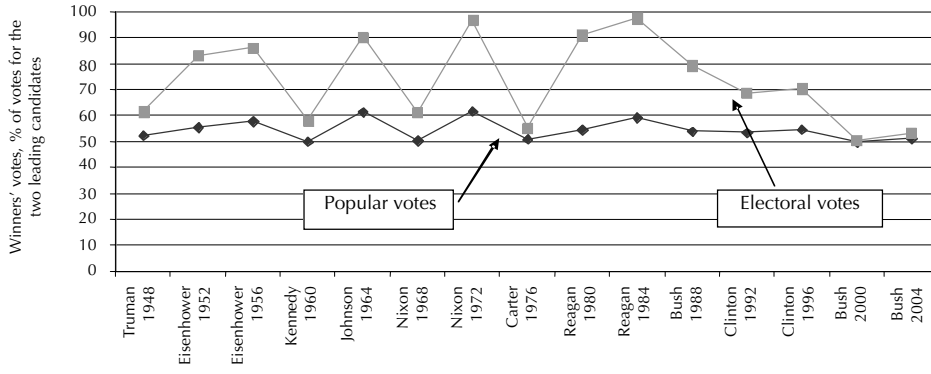


Figure 1.2 Increasingly thin majorities: US Congress elections

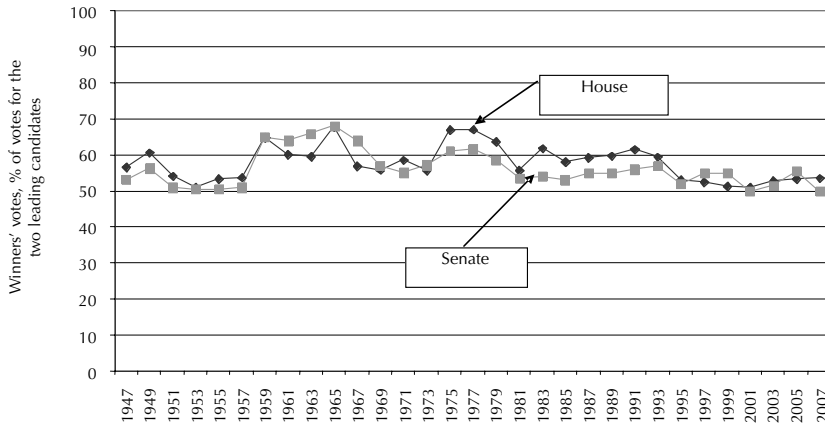
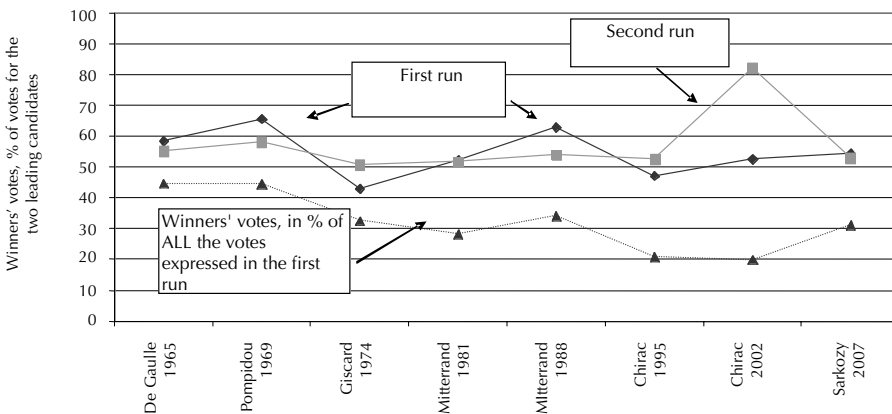


Figure 1.3 Increasingly thin majorities: French presidential elections



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Figure 1.4 Increasingly thin majorities: German Bundestag elections

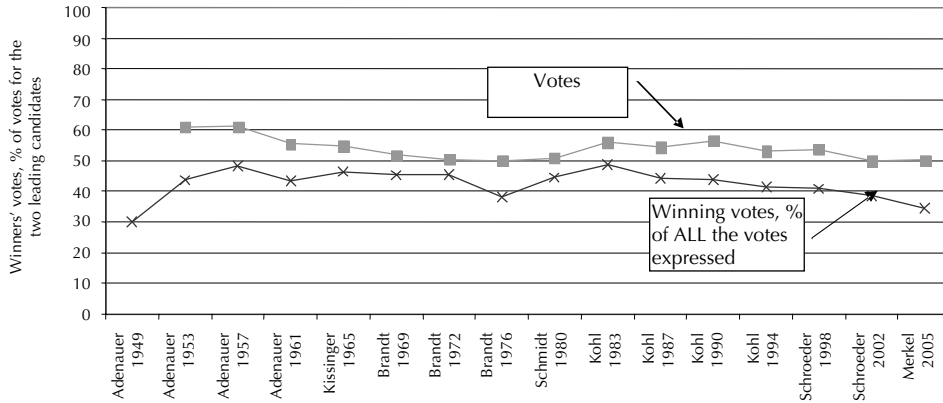
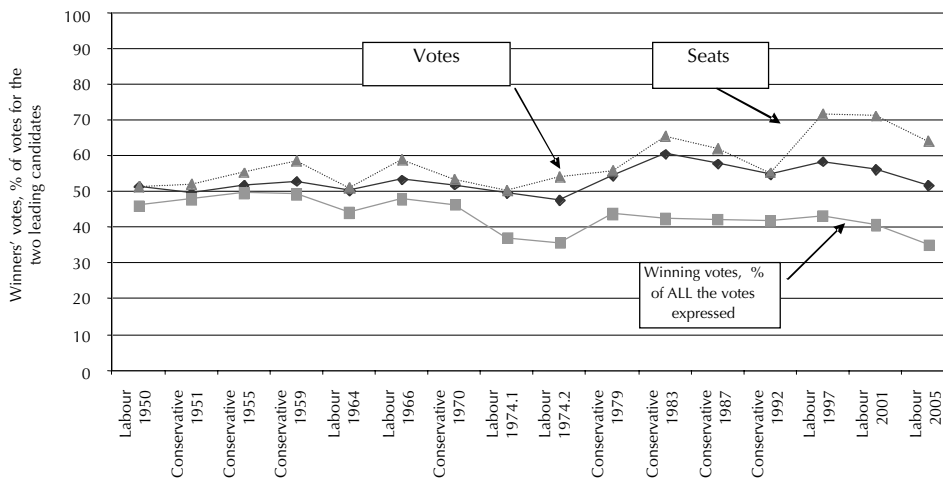


Figure 1.5 Increasingly thin majorities: UK House of Commons elections



US presidential elections are crucial for trade policy since it is the president who takes the initiative in trade negotiations – first by consulting trading partners, then by going to Congress to get approval for launching formal negotiations and finally by tabling a package acceptable to Congress.

Since the mid-1980s, the decline in presidential majorities has been phenomenal among the voters of the electoral college, which is the key to election outcomes under the US constitution. The proportion of electoral college votes in favour of the elected president has collapsed by 45 percentage points, with all-time lows in 2000 and 2004. The corresponding proportion of the American people's votes has also declined substantially, by 8 percentage points. Looking at the elections for Congress also shows a notable erosion of the majorities at both the House of Representatives and the Senate, by 8 and 6 percentage points, respectively, since 1991 (by almost 14 and 12 percentage points, respectively, since 1977).

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French presidential elections are also crucial for trade policy because the president plays a dominant role in foreign policy matters (his/her *domaine réservé*). These elections consist of two rounds (*tours*) with the two best-placed candidates in the first *tour* being the only ones allowed to run in the second *tour*.

Since 1988, the first *tour* has seen a decline in votes for the best-placed candidate compared with those for the second best placed candidate.⁵ But the best sense of the real political strength of an elected president is given by his/her votes in the first *tour* compared with *all* votes because this ratio captures the relative size of the core supporters of the elected president. The ratio has fallen dramatically – by 25 percentage points – since the first direct presidential election in 1965 (though the 2007 election of President Sarkozy shows an interesting reversal in this trend).

In Germany, the key elections are those for the Bundestag, the Lower House. Looking at votes or seats does not make a difference because the German electoral system allocates seats proportionally to votes according to a complex procedure intended to eliminate parties whose political support is small and potentially extremist.

Since the late 1980s, there has been erosion in the share of seats of the winning party compared with the seats of the losing party – leading all German governments since 1969 to rely on 'small' coalitions.⁶ In 2005, this erosion went so far as to require a 'grand coalition' of the two largest parties, the CDU-CSU and the Social Democrats.⁷ That said, the best illustration of the erosion of majorities in Germany is the decreasing share of the largest party (whichever it is) in total votes, a decline of 14 percentage points between its last highest peak in 1983 and 2005.

At first glance, the UK seems to be an exception to the hypothesis of increasingly thin majorities. Far from declining, UK winning majorities over the second placed party have come from an increasing share of votes since the mid-1970s, although there are some signs of erosion since 1983. This impression is amplified when looking at seats since the UK's electoral system gives a huge seat premium to the election winners.

But all these observations hide a contrasting development: the notable decline (by almost 10 percentage points) in the winning party's votes as a proportion of total votes. (This is due to the increasing number of votes in favour of a third party, which has never been able to get a substantial number of seats in the House of Commons.) This increasing gap between the majority in the House of Commons and the situation in the country has a cost. It requires careful handling by the Prime Minister, and hence limits his/her full authority.

5 The second *tours* do not show a very clear evolution because they reflect loose coalitions of voters. In 2002, the second *tour* was atypical, with the remaining conservative candidate, Jacques Chirac, running against the extreme-right candidate, Jean-Marie Le Pen. As a result, 'left' voters had little choice but to vote for Chirac.

6 The coalitions were as follows: the CDU-CSU with the Free Democrats (1969-1982), the Social Democrats with the Free Democrats (1982-1998) and then with the Greens (1998-2005). The CDU-CSU is itself a coalition of the Christian Democrats and the Christian Social Union (CSU). The CSU is based in one key German state (Bavaria) characterised by a strong farm lobby. The CSU votes are crucial since they represent, on average, 20% of the total votes for the CDU-CSU coalition when the coalition is governing (21.4% in the 2005 elections).

7 There was a first 'grand coalition' from 1966 to 1969.

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Do not count on leadership

Very little – if anything – can be done to change national constitutional rules. Indeed, proposed revisions generally tend to shorten presidential mandates rather than lengthen them, as illustrated by the change in the French constitution that cut the presidential mandate from seven to five years starting from 2002. From a trade perspective, such changes are counter-productive because reduced mandates make it more difficult for a president to support freer trade liberalisation, which is generally characterised by fast-emerging costs and late-arriving benefits.

Similarly, it is hard to see how to deal with the issue of increasingly thin majorities without endangering the basic functioning of democracies. Indeed, it is important to understand the reasons behind this development so as to have a sense whether it is a long-term phenomenon (triggered by higher incomes, which enlarge the range of possible social goals and hence lead to fragmented public opinion) or a transitory change potentially subject to rapid reversals.

In a nutshell, the current lack of political leadership may well be here for a long time. Of course, visionary and courageous leaders could emerge at any point in the future, and make a difference. But it would be foolish to count on them. The period when trade rounds were shorter than US presidential mandates, with the United States as the natural and benevolent leader, seems over.

To many observers, this lack of leadership seems to condemn the WTO to a long period of stagnation. They argue that this is already illustrated by the persistent difficulties faced by the Doha Round since 2001, and that bilateral trade agreements are the only remaining solution.

2 How strong are the winds of bilateralism?

Proponents of PTAs as the way forward for world trade see their views justified by the increasing number of PTAs concluded since the 1990s, culminating in more than 200 PTAs notified to the WTO as of September 2006. This number is quoted so often and its weight in the WTO debate is so heavy that it deserves attention before turning to substance.

A little bit of accounting

The following sentence (written three decades ago) suggests that immediate caution is necessary when considering the view that the boom in PTAs is a new phenomenon:

'The US draftsmen of the ITO [International Trade Organisation] Charter did not foresee that post-World War II commercial policy would be dominated by the rise of a multitude of regional agreements which would challenge the draftsmen's universal principles in the most fundamental manner.' (Dam 1970, own underline).

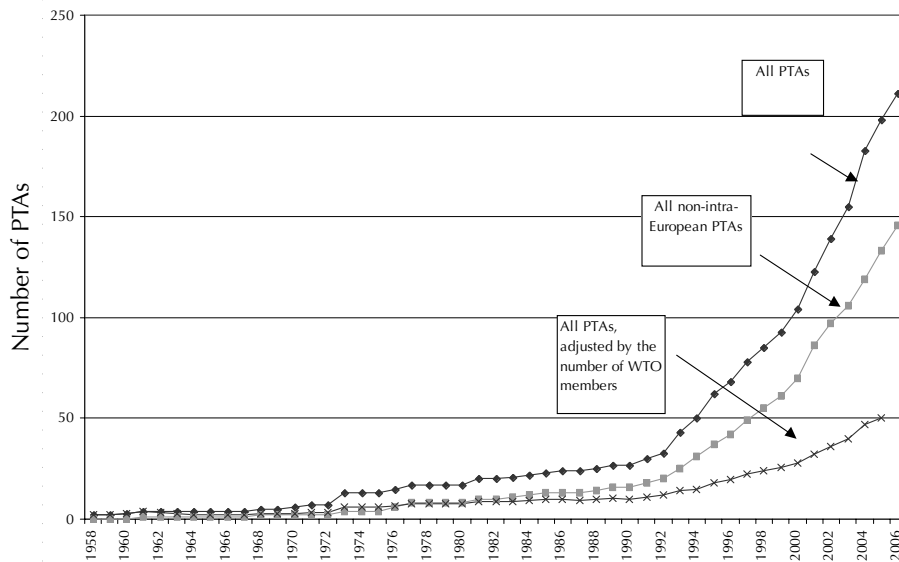
Keeping this in mind, Chart 1.6 shows that the quoted number of 200-plus PTAs gives a seriously exaggerated and misleading view of the recent attraction of PTAs (see also Pomfret 2006):

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- First, this number includes a very substantial proportion (more than 30% most recently) of intra-European trade agreements (defined as deals between countries located in the European continent, excluding Belarus, Russia and Ukraine). The large number of intra-European deals mirrors the inefficient way (from a purely institutional point of view) in which Europeans are building their 'single market'. Every time EU trade policy changes, a vast number of bilaterals can disappear (as when 10 countries joined the EU in 2004, or when the 27 PTAs between the Balkan countries were replaced by one deal under the EU's aegis in December 2006) or emerge (for example, if the EU implements a new policy on bilaterals as outlined by the European Commission in 2006).
- Second, the increase in the number of PTAs notified to the WTO to some degree reflects the increase in WTO membership. (For example, a substantial number of bilaterals involve former republics of the Soviet Union that have recently joined the WTO.) Chart 1.6 'deflates' the (increasing) number of PTAs by the (increasing) number of WTO members. The 'deflated' number of PTAs shows a much more modest increase of PTAs – a quarter of the unadjusted increase.

In short, simple accounting misses the key question: how many of the current 200-plus PTAs will survive? Answering this question requires making a distinction between PTAs that focus on market access – which tend to survive – and PTAs that focus on trade preferences – which tend to fail.

Figure 1.6 How to count Preferential Trade Agreements (PTAs)



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The rise and fall of preferences

In contrast with its positive view of unilateral or multilateral liberalisation, standard economic analysis finds it difficult to provide a clear answer about the net benefits of bilateral trade liberalisation (Schiff and Winters 2003). For most economists, bilaterals constitute a 'second-best' solution in the vast majority of cases – and second-best can be a long way from first-best.

The evidence confirms this dominant view, suggesting that bilaterals perform badly in terms of opening new markets. They are credited with only 10% of the world market opening that has happened between 1983 and 2003, compared with 65% for unilateral liberalisation and 25% for WTO-based liberalisation (World Bank 2005).

Such poor performance is not surprising for bilaterals established before the 1990s, which mostly involved countries enforcing high tariffs on imports from the rest of the world (so-called most-favored nation, or MFN tariffs). In these cases, the two signatories grant to each other high 'preferences', defined as the differences between MFN and preferential tariffs.

High preferences distort trade flows because they induce consumers to buy goods from inefficient production sources located in the two countries rather than goods more efficiently produced in the rest of the world. The higher the MFN tariffs (and hence the preferences), the more distorted the bilateral trade flows are likely to be, the higher the costs of the bilateral (compared with a multilateral liberalisation) are likely to be for consumers of the products imported from the trading partner, and the higher is the likelihood of the bilateral collapsing. If the EU has escaped this fate, it is largely because the MFN tariffs applied by its member states have been moderate since the EU's very early years.

Since the late 1980s, many countries have lowered their MFN tariffs. Logically, that should have triggered a loss of interest in bilaterals for two reasons: lower MFN tariffs generate reduced preferences; and they subject the pre-existing bilaterals to a painful 'erosion' of the initially granted preferences.⁸

So what explains the continuing attraction to bilaterals in a world with more moderate average applied MFN tariffs?

- First, it may simply reflect the fact that tariff cuts made since the late 1980s are far from perfect. High tariffs and/or non-tariff barriers have been kept on a substantial range of goods, hence ensuring high preferences for non-liberalised products.
- Second, most tariff cuts of the two last decades have been done in terms of applied tariffs not 'bound' tariffs. (Under WTO rules, only bound tariffs cannot be raised without compensating the affected trading partners, hence the importance of WTO negotiations on bound tariffs.) Today, bilaterals may offer limited preferences on applied tariffs, but

8 For example, following the fall of the Berlin Wall, the EU signed new bilaterals with the Central European economies, breaking up the existing ranking of preferences among its partners in bilaterals (most of them developing or least developed countries). The political strains of this development were so heavy that, in 1997, the EU decided on a 'pause' in its policy on bilaterals. It renounced the idea of new bilaterals and decided only to conclude the negotiations already in progress - succeeding with Chile and Mexico, but failing with Mercosur.

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still offer high preferences on bound tariffs, hence shifting the risk of tariff increases to the countries without preferential market access.

- Third, the two last decades have witnessed a shift of interest towards trade in services and freer international investment flows. The current WTO framework is loosely structured with respect to services liberalisation, and it has a minimal set of provisions on investment in services, and none in goods. That said, bilaterals on trade in services and investments may be attractive for the same reason that pre-1990s bilaterals were for trade in goods: the existence of high preferences. Hence they may be doomed to the same fate since today, most services are highly protected in most countries, as was the case for goods before the 1990s.⁹ The magnitude of this problem depends on whether discriminatory practices are hard to embed in services and investments bilaterals (Roy et al 2006).

The current pattern of Preferential Trade Agreements

Table 1.1 suggests a few key features of the current pattern of PTAs.¹⁰ First, the PTAs notified during the WTO years (post-1995) are almost exclusively bilateral trade agreements in sharp contrast with those notified during the GATT years (pre-1995), which are almost equally split between regional trade agreements and bilaterals.¹¹

This conclusion is reinforced by the clear drift from customs unions to free trade areas between the two periods. Trade liberalisation arising from free trade areas is severely limited (compared with customs unions) by the use of complex rules of origin.

Second, the breakdown of the non intra-European PTAs indicates that (in sharp contrast to what is widely believed) large countries have been followers rather than leaders in the recent wave of PTAs:¹²

- There is not one bilateral between economies in the top 10 (defined as those with the 10 largest GDPs, including those of individual EU member states, under exchange rates based on 'purchasing power parity' or PPP).
- There are only six bilaterals combining a top 10 and a top 20 economy. (In fact, these bilaterals consist of three 'pairs' of countries, where an

9 For example, questions are raised about the real impact of intra-European bilaterals (Aslund 2006).

10 Table 1.1 includes the agreements between the EU and the countries of Africa, the Caribbean and the Pacific (ACP) by counting the ACP as regional PTAs.

11 The change is underestimated by Table 1.1 to the extent that seven (out of the 10) regional agreements signed during the WTO years are related to EU trade policy with respect to the ACP countries, and may not have existed in the absence of this policy. The fading of regional agreements reinforces the conclusion reached in chart 1.5, according to which the mere accounting of PTAs grossly magnifies their recent economic impact.

12 Intra-European deals are definitively shaped by EU trade policy.

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agreement on trade in goods is coupled with an agreement on trade in services: US-Australia, Japan-Mexico and Thailand-Australia.)

- A third of bilaterals involve a top 10 economy with a 'small' economy (defined as an economy not among the top 20). The role of the EU and the United States is relatively limited, with the former slightly ahead of the latter (something worth noting when assessing the possible U-turn on bilaterals in EU trade policy).
- In relative terms, the top 11-20 economies have been more active than the top 10 economies in the last 10 years.

The mirror image of these observations is the large share of small countries in the recent wave of bilaterals. This reflects the long queue of trade ministers willing to negotiate a bilateral with the EU or the United States at the sudden end of the Cancún ministerial conference in 2003, though many of these ministers were very vocal on the risks of liberalisation a few hours before. Annex 1 offers reasons for the dominance of small countries in the recent increase in bilaterals.

Table 1.1 Preferential Trade Agreements notified to the WTO from 1958 to 2006, as of September 2006

	Number of agreements			Shares (in %)		
	All years	GATT years	WTO years	All years	GATT years	WTO years
PTAs by type and activity						
Regional vs bilateral PTAs	211	50	161	100.0	100.0	100.0
Regional trade agreements	36	26	10	17.1	52.0	6.2
Bilateral trade agreements ('bilaterals')	175	24	151	82.9	48.0	93.8
PTAs on trade in goods and on trade in services	211	50	161	100.0	100.0	100.0
Trade in goods: customs unions	8	5	3	3.8	10.0	1.9
Trade in goods: free trade areas	165	44	121	78.2	88.0	75.2
Trade in services	38	1	37	18.0	2.0	23.0
PTAs by type of signatories	211	50	161	100.0	100.0	100.0
Intra-European deals ^a	65	19	46	30.8	38.0	28.6
Deals with no signatory among the top 20 economies	35	5	30	16.6	10.0	18.6
Non intra-European bilaterals	146	31	115	69.2	62.0	71.4
Breakdown of the non intra-European bilaterals	146	31	115	100.0	100.0	100.0
with one signatory among the top 10 economies	51	6	41	34.9	19.4	35.7
with the US	17	3	14	11.6	9.7	12.2
with the EU	20	2	18	13.7	6.5	15.7
with one signatory among the 11-20 largest economies	34	1	33	23.3	3.2	28.7
with both signatories among the top 20 economies ^b	6	0	6	4.1	--	5.2
with no signatory among the top 20 economies	32	2	30	21.9	6.5	26.1

Sources: WTO notifications, WTO website; IMF data on GDP at PPP exchange rates.

Notes: [a]Trade deals within the European continent (includes the EU, EFTA, Bulgaria, Romania and Turkey, see text). [b]There is no bilaterals with both signatories among the top 10 economies.

The 2006 EU Initiative: launching a race to bilaterals?

In November 2006, Peter Mandelson, the EU's trade commissioner, released a working document spelling out the various options for Europe's trade policy (European Commission 2006). The document reaffirms support for the Doha negotiations. But it develops such a massive European strategy in terms of future bilaterals – no less than 24 bilaterals are envisaged – with such a sense of urgent need for action that it has left the strong impression of a change of course in European trade strategy if the Council decides to follow the Commission's proposal.¹³

The document was received rather coolly at the European Parliament, and it has not convinced a large share of the European business community about the need to go down the bilateral route (Wallenberg 2006; Seillière 2006). Since then, the Commission has tried to minimise the initial impression of haste – almost panic – without much success. But at the same time, it is pushing the member states' trade ministries hard to start feasibility studies as quickly as possible.

The Commission's document suggests that Europe is late in what is alleged to be a race to bilaterals, and hence that it should 'catch up'. Such a view is not supported by the evidence. Table 1.1 shows that Europe is still – by far – the most important source of bilaterals (a point confirmed in Table 1.2). The second most important source of bilaterals is small economies, and these are unlikely to threaten European trade flows.

The Commission's fears appear to be caused by the fact that, in recent years, the United States has seemed to have had the bilaterals game all to itself. This perception is not supported by Table 1.1, which shows that US-related bilaterals represent only 14% of all post-1995 bilaterals notified to the WTO (a result reinforced by Table 1.2 based on the size of the bilaterals in question).

In addition, there is little evidence of a strategic US approach to bilaterals. The US administration has mostly reacted to demands from (small) trading partners (Feinberg 2003) and taken few initiatives on bilaterals (establishing them only with Australia, Bahrain and Morocco) and these initiatives were fundamentally driven by foreign policy motives (the Iraq war).

In contrast to the Commission's approach, the United States has no pending 'grand vision' in terms of bilaterals. The Free Trade Area for the Americas looks to be a 'sleeping beauty', the US calls for an Asian-Pacific initiative are incantatory but inconsequential, while the US-China dialogue is more likely to reduce current trade flows between Asia and the United States, via exchange rate adjustments by Asian trading partners or via US retaliatory measures.

Finally, the ordeal of getting the recent bilaterals approved by Congress and the mood of the newly elected Congress (revealed in the request by the new Democrat majority to review the bilaterals) do not suggest that strategic changes are on the agenda.

In such a context, the Commission's aggressive approach could trigger precisely what the Commission fears – a race to bilaterals – to the extent that the proposal may push the United States and other large trading partners themselves to try to catch up in terms of bilaterals.

13 On April 23, 2007, the EU Council of Ministers approved draft negotiating directives, but only for agreements with Central America, the Andean Community, ASEAN, India and Korea.

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Table 1.2 Bilaterals: Three Strategies

	No. of partners	Market size ^a		Average industrial tariff ^b			Regulatory ranking ^c			
		at current US\$	at PPP US\$	applied	bound	trading across borders	dealing with licences	ease of doing business	registering property	protecting investors
	1	2	3	4	5	6	7	8	9	10
A. Bilaterals signed										
Chile	20	79.0	70.4	5.5	8.0	34.1	70.8	41.5	39.6	46.3
US	15	7.6	6.5	7.5	19.6	42.9	41.9	29.2	50.1	34.0
EU	14 ^d	6.4	8.2	9.2	18.3	76.8	91.9	67.1	80.4	53.4
B. Bilaterals under negotiations or consideration										
Chile	9 ^e	81.6	77.7	6.4	10.3	43.2	77.8	49.4	45.5	45.1
US	14	14.9	16.5	8.8	21.3	54.1	69.7	52.2	64.7	44.2
EU	24	23.4	44.2	10.3	17.8	71.1	125.6	91.2	61.8	64.8

Notes: [a] GDP (in USD, 2004) as a share of world GDP. [b] WTO Trade Profiles 2006. [c] Doing Business 2007. [d] Counting as one the 10 countries having acceded to the EU in 2004. [e] Counting as one the EU.

Assessing bilaterals under negotiation or consideration¹⁴

There is thus a strong need to go beyond impressions and intents by providing a few indicators showing what has been recently achieved in terms of bilaterals and what could be achieved if the current negotiations and those envisaged are concluded.

What follows does not attempt to do the usual economic analysis, that is, to estimate the net economic gains from bilaterals. Such estimates are notoriously difficult and their results are easily flawed. For example, they ignore the negative impact of the rules of origin on the real extent of bilateral liberalization, assuming that the two signatories of a bilateral will fully dismantle their respective trade barriers, and that the resulting situation will last for a long time. There are many reasons seriously to doubt these premises.

When assessing current and expected bilaterals, the crucial objective is to make the difference between bilaterals focusing on market opening (likely to be a 'stepping stone' to world trade liberalisation) and those focusing on market preferences (likely to be a 'stumbling block' to world liberalisation).

Table 1.2 presents simple but useful evidence in this respect. It focuses on the EU and the United States, but to provide a richer perspective, it includes a small economy, Chile, the world's most active signatory of bilaterals, as shown in column 1, which gives the number of co-signatories of the bilaterals involving these three countries.

Columns 2 and 3 show the GDP shares of the three countries' trading partners in world GDP (both at current and PPP exchange rates), giving a sense of the market *coverage* of the possible preferences related to the size of the trading partners involved in existing and future bilaterals. Combining the coverage indicator with indicators focusing on the *level* of preferences gives a sense of the *magnitude* (that is, the coverage times the level) of the expected preferences.

Columns 2 and 3 reveal a striking difference between the EU and the United

14 A detailed version of this section can be found in Messerlin (2007).

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States on the one hand, and Chile on the other for bilaterals signed and in force. The EU and US bilaterals cover a very low share of world GDP, whereas Chile's bilaterals cover almost three quarters of world GDP (10 times more than the EU and US coverage). Looking at the bilaterals under negotiation or consideration changes the picture dramatically. The Commission's aggressive approach is launching a real race to bilaterals, with the risk that the United States could react with its own aggressive strategy.

Columns 4 and 5 of Table 1.2 focus on tariffs, the first key instrument that could determine the level of preferences in trade in goods. Low applied average tariffs suggest that partners in the bilaterals have kept relatively few peak tariffs, and hence that they offer limited opportunities for preferences. With high applied and bound tariffs, such opportunities are more likely.

Columns 4 and 5 reveal another striking difference between the EU and the United States on the one hand, and Chile on the other for both existing and envisaged bilaterals. The average applied and bound tariffs of the EU and US co-signatories are relatively high, but they are low for Chile's bilaterals. In other words, the EU and the United States are, *nolens volens* (unwillingly or willingly) looking for tariff preferences – perhaps *nolens* with the US bilaterals since the United States has been mostly a follower, clearly *volens* in the proposed EU strategy.

Columns 6 and 7 of Table 1.2 focus on non-tariff barriers, the other key instrument that could determine the level of preferences in trade in goods. As there is no direct measure of such barriers, Table 1.2 relies on the ranking of the co-signatories of the EU, the United States and Chile in two respects: the ease of trading across borders and the ease of dealing with licences as estimated by the *Doing Business* database (World Bank 2006).

Rankings are crude indicators (there may be a much bigger difference between the first and second ranking than between the second and third ranking, or vice versa). But averaging the rankings of the co-signatories with the EU, the United States and Chile shows differences that are large enough to be meaningful. Columns 6 and 7 suggest that the EU is by far the country most focused on co-signatories with high non-tariff barriers, particularly with its recent strategy – once again, suggesting the intention of looking for market preferences.

Columns 8 to 10 of Table 1.2 attempt to deal with services and investments. They too use rankings from the *Doing Business* database. The services dimension is captured by the global indicator of the ease of doing business in the co-signatories, whereas the investment dimension is reflected by the quality of property registering and investors' protection in the co-signatories.

Once again, these three indicators contrast the EU on the one hand, with Chile and the United States on the other. The EU tends to look at markets that are highly protected by inefficient regulations – hence potentially offering high preferences – whereas the two others are more attracted by countries with relatively sound regulations. The results for the EU are largely, but not exclusively, driven by four targeted partners: Brazil, China, India and Russia. These four countries are not especially known for being easy partners with which to negotiate. It is difficult to see what the EU could get in a bilateral setting that it could not get in the WTO forum by forging an alliance with other countries.

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3 'Flexiplining' the WTO

Since bilaterals are far from being a panacea, the WTO remains the best option. But a 'quick fix' limited to a relaunch of the WTO negotiations (be it in 2007 or 2009) without a serious effort to reshape the WTO negotiating process is almost certain to have minimal results. These results could also be welfare-deteriorating because of the distortions introduced by the many exceptions envisaged by the negotiators, and by the economically unsound instruments to which the negotiators may have recourse for implementing these exceptions (such as tariff-rate quotas in agriculture).

To date, there have been scant efforts to reshape the WTO negotiating process. Indeed, the long Doha Round discussions on 'negotiating modalities' have gone in the opposite direction, making the WTO negotiating process more confused and inefficient, and hence benefiting the bilaterals.

Yet there are many possible sources of increased efficiency in the WTO negotiating process. The current process is a prisoner of interpretations that were shaped a long time ago (and were often very useful then) but which are harmful today, and can be challenged while fully abiding by WTO principles.

Six sources of greater efficiency stand out, all of which have a common goal: aiming for shorter rounds of trade negotiations. All these sources would help to conclude faster WTO rounds. They are also self-reinforcing, a characteristic that makes it possible for each of them to be used more gently, a useful feature for achieving compromises.

The proposals aim at 'flexiplining' the WTO process, on the one hand disciplining it – by focusing on the core business of market access; and by relying on formulas for negotiating market access in goods – and on the other hand, making it more flexible – by reassessing the value of binding tariffs; by relying on plurilaterals for negotiating market access in services; by reinterpreting the single undertaking principle; and by mellowing the bilaterals via some 'multilateralisation' of their rules of origin.

An important side effect of these improvements would be to reduce the attraction of bilaterals in general (and bilaterals focused on market preferences in particular) and to make current and future bilaterals friendlier to the multilateral trading system.

Before examining these points, the usual solution recommended today – a stricter use of GATT Article XXIV for monitoring bilaterals – deserves a comment. Although useful, this solution has no capacity (nor claim, to be fair) to relaunch the WTO negotiations. More crucially, it has very little chance of having an impact on the proliferation of bilaterals.

This is because it would rely on GATT Article XXIV for trade in goods (which has been authoritatively described as 'deceptive' and 'based on a legal error' – Dam, 1970) and its equally cryptic twin GATS Article V for trade in services. Years of negotiations would be needed to agree on a common interpretation of such deceptive provisions and their stricter use. In short, the solution may be operational too late, once the damage has been done with too many PTAs having been negotiated.

Aiming for shorter rounds

Having shorter rounds is not a new idea, but so far, it has been justified by unconvincing reasons:

- The first is negotiators' fatigue. But negotiators have fixed term assignments in the diplomatic traditions of many countries, and the alternative – a race to establish bilaterals – would be much more demanding for the negotiators, as well as for politicians, the business community and the general public.
- Second, it is often said that bilaterals can be negotiated rapidly, but anecdotal evidence does not support such an assertion.¹⁵

Aiming for shorter rounds is on much firmer ground when taking account of domestic political constraints (particularly those in the United States, the most important WTO player) and the erosion of the consensus in favour of freer trade caused by increasingly thin majorities in the major developed countries. Ideally, no round should last more than six or seven years, mirroring the constraint on US presidents.

Shorter rounds mean more limited objectives for each round. It is often argued in WTO circles that limited targets (a 'round light') are the kiss of death in domestic trade politics, especially in the US Congress. There is a great deal of rhetoric around this view, but not much evidence to support it. For instance, in 1994, the Congress passed the Uruguay Round, which had a limited trade liberalisation component per se but also offered long-term perspectives of liberalisation. More limited rounds need to be cast in a sequence of rounds, downplaying the always-deceptive concept of the 'big last one'.

A sequence of rounds would have many advantages. In particular, it would smooth domestic concerns about the high adjustment costs of any agreed liberalisation, a key point for both developed and developing countries. It would also have the huge advantage of making the WTO better able to catch up in services liberalisation by multilateralising bilaterals in services more frequently.

The WTO should focus on its core business: market access

The WTO should focus on its core business: market access in goods and services. It should not be burdened by other issues, which, sooner or later, have to be abandoned. The unceremonious abandonment of three of the so-called 'Singapore issues' (investment protection, competition policy and government procurement) at the Cancún ministerial conference in 2003 has shown the heavy cost of such miscalculations for the WTO as a whole, and for the EU, its staunchest supporter, in particular.

¹⁵ It is impossible to compare the negotiating time required by bilaterals and by WTO negotiations because of the high variability in the trade content of bilaterals. Vague provisions in bilaterals may indicate the absence of real commitments, or, alternatively, they may reflect a 'neo-imperial' aspect, particularly if they deal with basic principles (as is often the case with EU-related bilaterals).

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Developed countries have generally justified the introduction of issues other than market access by arguing that they have nothing left to offer in terms of market access concessions. This argument ignores several basic points:

- Most remaining tariffs of developed countries target exports from developing countries (Laird 2002). And while the high tariffs imposed by the developed countries on their imports of manufacturing products may be few, their economic value for developing countries' exporters is huge.
- The same can be said for developed countries' agricultural protection: it inhibits the growth of a critical sector for developing countries – particularly for the poorest ones – even if the importance of agriculture will diminish as and when these countries grow.
- The universe of services has largely been untouched by concessions on market access, although it represents 70% of developed countries' GDP and is of prime interest for most WTO members.

In short, there are still plenty of deals about market access to be done.

The best way to eliminate topics not closely related to market access is to deal with them in a better place than the WTO. This is particularly important for international investment because of the intrinsic importance of this topic, and because it has fuelled the recent move to bilateralism via bilateral investment treaties or investment provisions in bilateral trade agreements (OECD 2006a, 2006b).

The WTO is badly equipped to generate a multilateral framework of rules in international investment, hence to multilateralise investment bilaterals. The GATT text has no rule on international investment in goods, and the GATS text only has general provisions.

The OECD has lost its chance to host a worldwide agreement on investment because it mismanaged the last attempt to design such an agreement (Henderson 1999) and because it has too narrow a membership.

The International Monetary Fund (IMF) has the appropriate membership, most of the needed expertise and, last but not least, a need to redefine its role. The IMF (perhaps with the Bank of International Settlements) should thus waste no time in launching an initiative aimed at establishing a multilateral investment framework – undercutting any inclination on the part of WTO negotiators to grab the issue, especially if they feel jobless following an indefinite suspension of the Doha Round.

Market access in goods: using the Swiss formula to 'peel the onion'

At the Hong Kong ministerial conference in 2005, after four years of endless discussions on negotiating modalities, the Doha negotiators agreed, almost in despair, to use the Swiss formula for trade in industrial products.¹⁶

¹⁶ The 'Swiss' formula is $T=(r*t)/(r+t)$ where r is called the Swiss coefficient. This coefficient r defines the highest possible post-liberalisation tariff. When t is very small, $r/(r+t)$ approaches 1 so that T

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This was a huge step forward, which should be adopted permanently because the Swiss formula is an instrument of liberalisation that is both extremely efficient and flexible. From an economic perspective, it cuts tariff peaks by more than the smaller tariffs, hence maximising the economic benefits from trade liberalisation, and improving tariff revenues for countries needing this source of public revenue.

From a domestic political economy perspective, the Swiss formula puts more pressure on the beneficiaries of high tariffs but it reduces pressure on low tariff sectors, hence offering governments the opportunity to mobilise the support of the large number of moderately protected sectors against the few highly protected. In addition, it moves protection towards greater neutrality of protection across goods.

From a negotiating perspective, the formula offers, for any Swiss coefficient envisaged, instant and costless information on the post-liberalisation tariff rates, hence facilitating negotiations, especially for the poorest countries, which are short of negotiating staff.

The formula's efficiency makes it possible to treat various groups of countries differently by agreeing on different coefficients for each of these groups – a key feature that is helpful for addressing the single undertaking issue. In short, the Swiss formula is extremely well adapted to the concept of shorter but more frequent rounds.

Unfortunately, two decisions have combined to reduce the potential impact of the Swiss formula dramatically:

- First, the WTO negotiators agreed on various exceptions to the use of the Swiss formula for 'sensitive' industrial products.
- Second, they are still using a much less efficient formula in agriculture, combined with even more exceptions.

The potential coverage and magnitude of all these exceptions are so large that they remove the substance of the Hong Kong decision on the use of a Swiss formula for the base cut of tariffs.

Why such an impasse? First and foremost, the negotiators of the developed countries have stuck to a very narrow interpretation of the binding tariff principle, equating liberalisation with a change in which all *post-Doha bound* tariffs should be lower than *pre-Doha applied* tariffs.¹⁷

This interpretation has induced the negotiators of the developed countries to 'overshoot' their initial requests on industrial products by requesting 'too low base' Swiss coefficients from their trading partners, hence pushing the latter to react by requesting vast exceptions, and ultimately offering the EU and almost a dozen

equals t (post-liberalisation tariffs will be about the same as the low pre-liberalisation tariff). When t (pre-liberalisation tariff) is very high, $t/(r+t)$ approaches 1 so that T (post-liberalisation tariff) equals r .

17 In addition, clearly many negotiators did not initially realise that a Swiss coefficient defines the highest possible post-Doha tariff for initial tariffs much higher than those observable in the real world. For example, if the coefficient is 20, the post-Doha tariff becomes higher than 19% for a pre-Doha tariff close to 500%, a tariff level very rare in the real world. For the highest tariffs not too rare in today world (say 100%) the post-Doha tariff with a Swiss 20 is only 14%.

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developed countries (the so-called G10) the opportunity do the same in agriculture. This sequence of events has made the final package of concessions in industrial and agricultural products unpredictable to the point of becoming useless.¹⁸

That said, it is unrealistic to believe that multilateral trade negotiations could be based on a mere formula *without* exceptions. The implicit trade-off between any level of the Swiss coefficient and the magnitude of the accompanying exceptions (the higher the Swiss coefficient, the smaller the demand for exceptions) should be made as clear and predictable as possible. Expressing the exceptions in terms of (a) Swiss coefficient(s) higher than the base Swiss coefficient over an agreed number of tariff lines would meet these conditions of clarity and predictability. For example, if the base Swiss coefficient is 25, exceptions could be subject to a Swiss coefficient of 60 for 2 percent of the tariff lines, and to a Swiss 40 for 3 other percent of tariff lines (for more detail, see Messerlin 2007).

Shorter and more frequent rounds mean that agreeing on a higher Swiss coefficient (that is, on a lower level of liberalisation) may be the price to be paid for granting fewer exceptions in the current round. This price is affordable, however, because it will not be paid for a long period of time if there is another round coming in the not too distant future. In short, repeated use of the Swiss formula should work like peeling an onion.

A necessary condition: reassessing the value of binding tariffs

One necessary condition for efficient use of the Swiss formula is a reassessment of the 'bound tariff principle'. Bound tariffs are the only ones to generate legal commitments in the WTO, and the principle makes a lot of sense from an economic point of view. The evidence shows a strongly positive relationship between a low level of average 'tariff water' (the difference between a country's bound and applied tariffs) and good domestic governance (as measured by the above-mentioned ease of doing business indicator) among WTO members.

That said, the current interpretation of the bound tariff principle (which equates liberalisation with a change in which all *bound* tariffs enforced after a round should be lower than the tariffs *applied* before the round) misses a key point. This is the fact that the Doha Round occurs at a very special time, that is, at the end of a period where many developing countries have substantially lowered their applied tariffs, while leaving largely untouched their bound tariffs.

As a result, 104 WTO members (out of 143) enforce applied tariffs lower than their bound tariffs, with 70 of these members with an average tariff water higher than 10% (WTO 2006). Tariff water can reach impressive average levels in some cases (around 100%). Out of these 70 countries, 21 can be classified as emerging economies with the rest being developing countries.¹⁹

18 As usual in negotiations, once the exceptions were written down in the July 2004 text, it becomes very difficult to negotiate a trade-off based on 'buying' a lower level of exceptions with a higher Swiss coefficient.

19 All the existing coalitions have strong links with the bound tariff issue. 23 out of 24 small and vulnerable economies, 29 out of the 32 LDCs, 32 out of the 38 members of the G33, and five out of the six recently acceding members exhibit average tariff water. The averages are high (respectively 37.3%, 32.8%, and 31.3%) except for the recently acceding members (3.2%), a striking illustration of the unbalanced situation faced by the new members.

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This special situation makes it easy to understand why the current interpretation of the bound tariff principle is a major stumbling block in the Doha Round. But there are three good reasons to challenge this interpretation:

- First, if binding has a value because it brings legal certainty, cutting bound tariffs has a value for businesses even if these cuts leave existing applied tariffs unchanged. Such an interpretation is particularly suitable to the Doha Round characterised by large tariff water offering the opportunity of large cuts in bound tariffs – hence boosting certainty in trade relations and, by the same token, likely to generate larger trade flows even if not delivering cuts in applied tariffs.
- Second, the cost of the remaining tariff water after a Doha deal should not be assessed in absolute terms, but in relative terms shaped by international factors. For example, the fact that India would bind some of its tariffs at a level higher than their currently applied rates represents an affordable risk for its trading partners because of China's trade regime. If India wants to be as attractive as China for traders and investors, it has to offer roughly the same tariff conditions as China. In short, Chinese bound tariffs work as proxies of bound tariffs in India (and a few economies at the same stage of development). 'Peer pressure' counts.
- Third, the value of a country's bound tariffs for its trading partners may also depend on domestic factors, in particular, the dispersion among the country's tariffs. Because protection granted to some domestic producers gives them an advantage to the detriment of other domestic producers, domestic producers lobbying for an increase in a given applied tariff are likely to face increasing opposition from their fellow domestic producers as and when the requested tariff increase comes closer to the country's highest existing tariffs. So the more dispersed the tariff rates imposed by a country, the riskier its unbound tariffs for its trading partners and the higher the value of binding for these trading partners.

It is worth noting that the link between the value of binding and domestic tariff dispersion has an important corollary. There are strong incentives not to raise applied tariffs in a country that is enforcing a 'uniform' tariff (the same tariff on all the products it imports) even if these tariffs are not bound. This is because domestic producers would immediately oppose a move favouring one of them (the producer getting a higher tariff) but disadvantageous to all the others.

It is not by accident that two (Chile and Singapore) out of the three WTO members that have unilaterally adopted a uniform tariff structure have still not bound their tariffs at their applied level (the tariff water is huge for Chile, which has bound its industrial tariffs at 25%, while applying a uniform industrial tariff of 6% (WTO 2006)). The more uniform a country's tariffs, the less likely it is that the absence of binding these tariffs will have negative consequences for the trading partners of this country.

To sum up, the demand for binding tariffs should be modulated so as to take

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account of the 'transitional' feature of the Doha Round, the intensity of 'peer pressure', the magnitude of dispersion of the tariff structure of the country in question, and the level of flexibility in the interpretation of the single undertaking.

Market access in services: plurilaterals and 'coalitions of the willing'

Opening markets in services requires trust in partners for undertaking adequate pro-competitive regulatory reforms. Trust is all the more necessary because regulatory reforms call for a dynamic process of continuous changes, which is very hard to forecast when negotiating the initial trade agreement.

The huge WTO membership is so heterogeneous in terms of both regulatory capacities and willingness to undertake the necessary reforms that the WTO forum would have hard time to generate the trust so much needed for reaching substantial liberalisation in services. This explains the attraction of bilaterals in services, particularly on the transitory movement of persons (mode 4). But it remains that bilaterals can be very costly because the high level of protection in services implies the existence of high market preferences with their strong negative consequences.

At the Hong Kong ministerial conference in 2005, the Doha negotiators took a first step towards enhancing the WTO negotiating process in services when they agreed to undertake negotiations in a 'plurilateral' framework, one limited to the countries willing to open their markets on a sector-by-sector basis. This initiative is close to a very successful negotiating process used for the first time at the Singapore ministerial conference in 1996 for the financial services agreement and the information technology agreement, both of which have been successful.

Plurilaterals at the WTO offer a good compromise between bilaterals and the fully multilateral approach if they address a few essential issues (Adlung 2006; Hoekman 2006). In particular, they should define the 'critical mass' of members (in number or economic size) to be reached for potential agreements to become actual agreements. They should also design the 'reference papers', spelling out the basic regulatory disciplines that the signatories should aim at establishing in each service sector. And they should ensure that any latecomer to a sectoral agreement will not be subject to commitments other than those included in the agreement.

In addition to generating plurilateral agreements, an essential role of the WTO in services liberalisation should be to multilateralise the existing or future bilaterals in services. From this perspective, rounds should be relatively frequent so as to avoid leaving too long periods without opening up the possibility of launching a catch-up process.

To conclude, it is important to note that the huge domain of services (by far, the most important in size and potential welfare gains for the coming decades) offers a good intrinsic reason to have more frequent rounds.

Reinterpreting the single undertaking principle: 'positive discrimination'

The prevailing interpretation of the single undertaking principle is that every WTO member shall sign all the agreements negotiated during a round. This principle was adopted in the Uruguay Round, when it was felt necessary to make the multilateral trading system more consistent. At that time, such an interpretation made sense for two reasons:

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- First, the Uruguay Round agreements concentrate on general goals and rules (liberalising trade in agriculture and services, regulating subsidies, norms and standards, etc.) that every WTO member should agree on to ensure a minimal consistency of the multilateral trading system.
- Second, the Uruguay Round negotiations on market access remained de facto limited to industrial products, a process initiated so many years ago that it was rightly felt reasonable to involve all WTO members, all the more because many developing countries were unilaterally liberalising.

Ten years later, such a strict interpretation is backfiring. It has greatly compounded the problems from enlarging the WTO membership by making the negotiating process a hostage of the members that are the most reluctant to liberalise.

And, it has also fuelled a process of systemic evasion of the WTO framework through the definition of groups of members getting exemptions from various specific obligations – 'negative coalitions'. The 'least developed countries' (LDCs) were the first to get special status, early in the Uruguay Round. They were followed by the 'net food importing developing countries' during the very last days of the Uruguay Round negotiations. Since the launch of the Doha Round, other exceptions have been tabled: the 'small and vulnerable economies', the 'cotton producers' and the 'recently acceding members', etc.

And the list is not closed. In particular, there is the increasingly loud request by a substantial number of developing countries to have a status distinct from those enjoyed de facto by the emerging economies and de jure by the LDCs. If such a new negative coalition is created, very few 'developing countries' would still be abiding by all the WTO rules, making a mockery of the single undertaking principle.

Even worse, such an approach (based on the skills of negotiators able to sneak in their country at a propitious moment) generates an irrational, chaotic and ultimately unjust WTO forum: some recent members do not enjoy LDC status although they are as poor as the richest LDCs; many members are more genuinely dependent on food imports than the few that extracted this special status 10 years ago (Zedillo and Messerlin 2005); and the coalition of small and vulnerable economies includes the 68th largest economy in the world (out of 182).

Such an approach based on 'negative discrimination' is unsatisfactory on several other grounds:

- First, it requires finding objective criteria for defining negative coalitions. The task has not been too difficult when defining the 'poorest' countries (although there are still pending questions) but it is much harder in all the other cases, as best illustrated by the small and vulnerable economies' struggle to define their own group.
- Second, agreement from members not pertaining to a proposed negative coalition may be hard to get in some cases, which risks blocking up the whole WTO machinery for years.

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- Third, once created, negative coalitions are hard to dissolve (even if the rationale behind them has disappeared), which means that exceptions are granted for a long period (forever?).
- Last, and perhaps crucially, a negative coalition tends to be a 'prison' for its most dynamic members to the extent that it is very difficult for one to break ranks and opt for a freer trade policy if it suddenly realises that it is in its own interests.

The WTO is thus at a crossroads. Either the current strict interpretation of the single undertaking will prevail and there will be persistent centripetal forces for 'group exceptions', which break up the WTO forum. Or the single undertaking principle is reinterpreted in a way that pre-empts the creation of such negative coalitions. In this perspective, it should be conceived as enforceable at distant periods of time, not continuously.

Between two enforcements, the negotiation process should allow members to 'discriminate positively', that is, to open their markets further by participating in plurilateral agreements without waiting for an agreement among all members – an extension of the approach suggested for services.

A key side-benefit of this positive discrimination approach would be to reduce the pressure imposed on the WTO system by its vastly enlarged membership. By definition, plurilaterals will involve a lower number of countries. This will dramatically change the level of nuisance that reluctant countries cause for the whole system. The lower the critical mass of signatories needed for a plurilateral agreement, the easier it will be for the plurilateral to avoid being the hostage of reluctant negotiators.

Of course, a positive discrimination approach would require several clarifications:

- First, which topics should be covered by a positive discrimination approach? An obvious candidate is public procurement. By contrast, tariff cuts in industrial products should still involve all members because it has been the core of the multilateral trading system for five decades, and all the more because a subtle use of the formula approach can provide all the necessary flexibility.
- Second, the coverage issue determines the extent of the legal difficulties for enforcing the dispute settlement mechanism in a WTO based on positive discrimination. However, it is worth noting that such legal difficulties are also likely to emerge in a WTO based on negative discrimination.
- Lastly, how much time should elapse between two enforcements? There is no a priori answer to this question. It depends on the boldness of the liberalisation moves made by the coalitions of the willing, and on the winds of bilateralism versus those of multilateralism.

Mellowing the bilaterals: multilateralising rules of origin

The suggestions for reforming the WTO negotiating process should greatly reduce the attraction of bilaterals in general. By targeting protection peaks in goods and services, they should particularly cut the ground under the bilaterals that focus on trade preferences – the most costly type of bilaterals for the signatories as well as for the multilateral trading system.

That said, bilaterals are unlikely to disappear totally, if only because some of them have a political dimension that puts them well outside the WTO's remit. So there is a need to reduce the harm that existing and future bilaterals could do to the system.

The rules of origin imposed by bilaterals are generally seen as the biggest source of problems created by these deals (Baldwin 2006; Cadot et al 2006).²⁰ Multilateralising these rules seems to be the best way to reduce these costs significantly. It is a hard task because the many criteria that define rules of origin (tariff schedules, tariff level, content level, sectoral specificities, etc.) change from bilateral to bilateral (Cadot and de Melo 2007). Harmonising rules of origin seems largely out of reach in the short to medium term, except around hubs (the EU or the United States) with the risk that such hubs could generate substantial perverse (trade diversion) effects.

As a result, the most accessible option for multilateralising rules of origin seems to rely on the notion of 'equivalent' tariffs, that is, tariffs close enough to each other to have no noticeable differences in their economic impact. A minimalist option would be to consider all the tariff lines with *tariffs* comprised between 0% and (say) 5% enforced in the world as equivalent, so that all the products subjected to such tariffs would be considered of 'domestic' origin.

A more ambitious option would be to define all tariff lines with tariff *margins* smaller than (say) 2% as equivalent (that is, a tariff of 8% would be considered as 'equivalent' for the rules of origin purposes to tariffs within the range of 6% to 10%). It is useful for observers that both versions have the additional advantage of inducing WTO members to shift their applied tariffs close to the ceiling tariff inside the tariff band.

4 Conclusion

Of course, there is no way to impose shorter rounds on sovereign WTO Members. But, the six suggested proposals would generate forces inducing to make rounds shorter and more frequent. Moreover, these proposals support each other, so that each of them could be used more gently, a feature favouring compromise. And none of them infringe the basic principles of the current multilateral trading system: they merely reassess current interpretations of those principles.

20 Paradoxically, strict rules of origin may be positive from a WTO perspective because they limit the impact of the bilaterals to such a degree that their signatories ultimately have to have recourse to the existing multilateral trading system. But this argument is limited to the bilaterals focusing on trade preferences, and it ignores the fact that strict rules of origin generate a high level of frustration, which ultimately hurts the WTO regime as well.

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Which countries could be the 'agents' of such an effort? An easy answer is the United States, Japan and the EU, still the three largest economies and those with the longest experience in the WTO.

But if these countries are necessary, they are not sufficient. The current balance of power in the WTO forum and a really business-friendly perspective require broader support, which demands an active role from medium-sized economies.

For obvious reasons, the GATT/WTO history has always focused on the largest players, with the US-EU *tête-à-tête* of the 1960s to the 1980s, the Quad (Canada, the EU, Japan and the United States) in the 1980s and 1990s, and the Five Interested Parties (Australia, Brazil, the EU, India and the United States), which came to an agreement on the essential elements of a Doha Round outcome on agriculture in 2004.

But in the past, the role of the medium-sized economies has always been essential for moving the GATT/WTO process at critical times. Australia, Canada, Colombia, New Zealand, Sweden, Switzerland, etc., have often been critical for preparing crucial deals. Medium-sized Asian economies, such as Korea, should join that group as soon as possible.

This chapter has focused on the WTO per se. But the success of WTO negotiations – and of trade liberalisation – ultimately depends on domestic forces operating within the members. Strong domestic support is essential for a more efficient WTO negotiating process. Such support should be stated not exclusively in general terms (average tariff cut, gains from trade and domestic regulatory reforms, etc.) as it is too often today, because such terms are difficult to grasp by the general public.

Rather, domestic support should focus on providing the best possible, most concrete information on the highest domestic barriers – peak tariffs on imports of goods, the most inefficient regulations in services, the highest subsidies in goods and services, etc.

Paradoxically, and ironically, support focused on peak protection would also help negotiators. For instinctive reasons, trade negotiators tend to ask more from their trading partners than their own businesses request. For example, European negotiators have insisted on tariff cuts from emerging economies larger than those initially requested by EU businesses (Messerlin 2007).

A focus on peak protection would help to dissipate a frequent misunderstanding among the general public: that protection is in the 'public interest' whereas freer trade favours narrow 'private interests'. After all, economic analysis, history and good political sense suggest that, by definition, protection is maintaining the status quo, and hence that it can only favour the most powerful groups in society to the detriment of other groups.

For example, the debate on agricultural protection has profoundly changed in Europe since the Doha ministerial conference in 2001, shifting from generalities on farm liberalisation to a very concrete point, that is, the largest beneficiaries of the current subsidies. As a result, not only are Europeans in favour of serious cuts in subsidies, even in France (German Marshall Fund 2006), but the most dynamic European farmers are beginning to distance themselves from the existing system of agricultural protection, the EU's common agricultural policy.

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Annex 1: Why Small Countries Turn to Bilaterals

The continuing attraction of bilaterals is driven not only by the pure economic costs and benefits to be expected from them. It flows from political economy considerations based on the domestic costs and benefits of concluding bilaterals relative to those of concluding WTO deals. This approach is interesting because it offers an explanation of the leading role of the small countries in post-1995 bilaterals suggested by Table 1.1 – a fact that the optimal tariff approach often used by the economists for analyzing the creation of preferential trade agreements cannot grasp.

From a small country perspective, the balance of domestic forces is likely to be the same, or even to be more favourable, with a bilateral than with a WTO deal. The small country's import-competing industries are likely to face roughly the same competitive forces in the case of a bilateral with a large country than in the case of a WTO agreement because the large country's producers are roughly as efficient as world producers for a wide range of goods.

Meanwhile, the small country's exporters are likely to perceive a bilateral as providing them as many as export opportunities than a WTO agreement because the large country markets are large enough to absorb their export capacities. (These opportunities may even be higher if the bilateral excludes the small country's competitors.) The second reason shifts the balance of domestic forces in favour of a bilateral compared with a WTO deal, pushing small countries to be 'leaders' in terms of bilaterals.

From a large country perspective, the domestic costs and benefits of a bilateral relative to a WTO deal are quite different. A bilateral subjects the import-competing industries of the large signatory to much more limited competition than a WTO deal, and it provides much more limited opportunities for domestic exporters than a WTO agreement. In sum, a bilateral with a small country may simply get unnoticed in the large country, hence the large country's tendency to be a 'follower'.

Going beyond pure trade interests, bilaterals can be attractive for three other reasons. First, they are a much more malleable foreign policy instrument than a WTO deal. Many negotiations on trade bilaterals have been launched on the assumption that they will strengthen political relationships that are in their infancy, or that they will rejuvenate fading political relationships. Once again, this feature is likely to reinforce the leading position of the small countries: it is much more rewarding for a small country to talk to a large country than the other way round.

By contrast, the WTO is a place where political considerations are 'dissolved' by the non-discriminatory principle. This feature may be very useful in specific cases (for example, the accession of Iran to the WTO would make it possible to avoid direct talks between Iran and the United States while still allowing them to open their markets to each other). But the WTO can hardly help to smooth the ups and downs of day-by-day international relations.

Second, bilaterals are also a much more malleable domestic policy instrument than a WTO deal. Trade ministers are generally junior ministers with little or no control over their country's global political agenda: the timing of the liberalisation programme, the scope of the industries to be covered, the balance of the domes-

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tic interests to be included, etc.²¹

Bilaterals fit much better with the limited power of trade ministers (and their hope for more prestigious ministerial portfolios) because they offer more freedom than WTO negotiations in managing the timing and the marketing of the deal, carving out its coverage and defining the domestic interests to be involved. By contrast, WTO negotiations are hard to manage in terms of timing, they are exposed to negatively charged media and are hence difficult for junior trade ministers to handle, and their scope is not under control since it has to accommodate a large number of members.

Third, bilaterals have the formidable capacity to include 'trade-related' issues too contentious to be managed easily in the WTO. These so-called 'WTO-plus' issues range from intellectual property rights enforcement (TRIPs) to geographical indications to competition policy. But the capacity of bilaterals to deliver WTO-plus provisions may be their Achilles' heel for two reasons:

- First, WTO-plus provisions included in bilaterals tend to be much stricter than similar WTO provisions (Fink and Reichenmiller 2005). Indeed, they are often introduced by the large signatory with the hope of re-importing them into the WTO forum.
- Second, the implementation of WTO-plus provisions may be more closely monitored by tailor-made provisions included in the bilaterals. As a result, WTO-plus provisions in bilaterals can easily pave the way to a 'neo-imperial' approach pursued by the large country, all the more because they generally deal with truly domestic 'behind-the-border' policies.

In sum, taking account of trade and non-trade interests suggests that negotiations on bilaterals between small countries and large countries are likely to be successful. But this conclusion has limits, the first two of which mostly concern the small signatories:

- Not only bilaterals create a huge source of rules-related problems (for instance, rules of origin) but they have difficulties handling other crucial 'rules' problems, such as subsidies (it is impossible to design subsidies so that they would have no impact on specific trading partners, as best illustrated by the severe difficulties faced by Mexico with subsidised US maize).
- The neo-imperial dimension of the WTO-plus provisions creates serious risks of bitterness and conflicts in the small signatory, as illustrated by the TRIPs dispute between Thailand and the United States, or by the recurrent disputes between the EU and Turkey.

21 There are exceptions, such as Australia or Chile, where trade policy is so much intertwined with foreign policy that it is handled by their foreign affairs ministries. In the case of loose federal unions (such as the EU) bilaterals offer room for autonomous initiatives to the trade ministers of the union's member states.

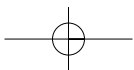
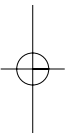
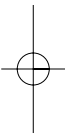
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The third limit mostly concerns the large signatories. The tiny costs and benefits of bilaterals with small countries are not for them an insurance against sudden and violent opposition from strong and tiny vested interests at home, which may have sufficient magnitude to stop (or at least endanger) an envisaged bilateral, as best illustrated by sensitive farm or food products (such as sugar, bananas and tuna).

This discussion deserves a final remark. The arguments above suggest that bilaterals between a large country and a 'not-so-small' country are doomed to be much more difficult, as best illustrated by EU-Mercosur negotiations or by the US-South Africa case. This is because the domestic balance between the relative costs and benefits of bilaterals compared with WTO negotiations is likely to be negative in both countries.

In the large country, import-competing industries may, with good reason, fear that the competitive pressures of the not-so-small partner's exporters could be as powerful as those generated by full-scale WTO negotiations (especially if the not-so-small country's exporters are among the most efficient in the world, as are Brazil's sugar producers), triggering the same strong opposition to a bilateral as to a WTO deal. And the large country's export interests are likely to continue to find the market access opportunities offered by the bilateral much less interesting than those provided by a WTO deal – simply because the markets of the not-so-small partner may still be significantly smaller than the world markets available with a WTO deal.

Meanwhile, in the not-so-small country, the exporters' lobbies may find the large country's markets not large enough for their export capacities, whereas the import-competing lobbies may be as afraid of the large country's competitors as of those from the entire world. This is why the fate of the preferential trade agreements involving Korea, the archetype of a 'not-so-small' country, will be so interesting to watch.



2 Reviving the Doha Round: The Agenda for the Developing Countries

Alan Deardorff, University of Michigan
Robert Stern, University of Michigan
and
John Whalley, University of Western Ontario¹

If the Doha Round of multilateral trade negotiations fails, the biggest losers will be developing countries. This chapter explains why, and goes on to examine various options for the developing countries either to avert or to deal with this potential failure.

Section 1 looks at the history of trade negotiations that led to the current impasse, while Section 2 explores the commonalities and differences in the interests of developing countries in the negotiations. These depend mostly on the sectors in which they export, either to developed countries or to each other. Their interests in reducing trade barriers and subsidies in developed countries are mostly either coincident or non-conflicting, but their interests in reducing barriers among themselves sometimes put them at odds.

Nonetheless, it is encouraging that developing countries are making efforts to negotiate collectively, for example, through the Group of Twenty (G20), a bloc including Brazil, China and India, which came together at the Cancún ministerial conference in 2003. But it is important that the G20 and other such groups do not limit their cooperation to pushing developed countries to liberalise: they should also work among their members to secure their own liberalisation. Without that, the Doha Round cannot succeed.

At the same time, there is a confounding factor in the trade preferences that some developing countries already enjoy from developed countries. They are well aware that multilateral liberalisation will erode these preferences, giving them incentives to stand in the way of successful negotiations.

Section 3 examines the role of developing countries in the structure of past and current negotiations. In the past, that role has been limited, largely because they were exempt from making 'concessions' and because the developed countries were willing to provide 'special and differential treatment'. Special treatment is still needed, but not in the form that has sidelined developing countries from the benefits of previous liberalisations. Instead, their liberalisation needs to be met by resources from developed countries and international institutions to assist them in opening their markets.

¹ This chapter builds on an outline that John Whalley intended to use for a paper for this project, and the authors are grateful to him for permitting them to follow his lead. They are also grateful to him for comments on an earlier draft, as well as to Riccardo Faini and Drew Brown who provided comments – and particularly to Bruce Blonigen, who enlisted them to write the chapter and gave detailed suggestions for its revision.

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Section 4 evaluates several options that may be available to developing countries both within and outside the context of multilateral negotiations. The first and most promising option is for developing countries to act collectively to rein-vigorate the World Trade Organisation (WTO), the international body that oversees the multilateral trading system, and the Doha Round negotiations.

But for this purpose, it is essential that they declare themselves willing to open their markets significantly in return for liberalisation by developed countries. Not only is this necessary for the round to succeed, it is crucial for developing countries to recognise that it is they, not the developed countries, which stand to gain the most from a successful round.

If the Doha Round does not succeed, and perhaps even if it does, developing countries have the option of establishing regional and/or bilateral trading arrangements, either among themselves or with large developed countries. But there is little benefit in such arrangements among themselves, and there are dangers in arrangements with large developed countries because of 'asymmetries' in their leverage over the many non-trade issues that routinely enter such agreements.

Nonetheless, regional agreements are making small but positive steps in the direction of multilateral free trade. These steps could be improved if they were designed to permit easier expansion to include more countries, as well as 'rules of origin' (the criteria used to define where a product was made) that are more all encompassing.

Other options include 'aid for trade', a small but obviously desirable initiative that is being encouraged both within the Doha Round and by the international financial institutions.

Another option is negotiation of focused initiatives in sub-areas, such as a single industry or category of trade. But these are of doubtful benefit to developing countries, since they are likely to lack the potential for trade-offs that would expand their benefits beyond the immediate gains from trade.

For the same reason, unilateral liberalisation by developing countries with trade barriers that are already low or moderate should not be encouraged. High-barrier countries could gain from unilateral liberalisation, of course. But once barriers are low, the benefits from further unilateral liberalisation are outweighed by the benefits of using those barriers as bargaining chips to secure greater market access abroad.

1 **How the Doha Round reached its current impasse**

The Doha Round of multilateral trade negotiations began in 2001, with high hopes that real progress would be made both by and for developing countries, for the first time in the history of trade rounds. Although many issues were on the table, the two central ones were the most difficult to address:

- Developed country protection and subsidies in industries of interest to developing countries, especially agriculture.
- Developing countries' tariffs on non-agricultural products and other restrictions on market access, including in services.

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In the event, these issues have proved to be so difficult that the negotiations have been characterised by their lack of progress. The Cancún ministerial conference in September 2003 ended without even the beginnings of a negotiating text having been agreed. A text was achieved the following year, but the next ministerial conference – in Hong Kong in 2005 – ended in success only because the criteria for success were much reduced and almost meaningless.

In July 2006, the WTO's director-general Pascal Lamy finally acknowledged that the negotiations were getting nowhere and would fail to meet the deadline imposed by the mid-2007 expiration of the US president's 'fast track' authority from Congress for a full mandate of negotiations. Lamy therefore suspended the negotiations.

Today, although various efforts are being made to revive them, the negotiations remain in a state of suspended animation. Developing countries must ask themselves whether their interests still lie in the uncertain future of the multilateral initiatives, or whether they should instead look at alternative approaches to integration with international markets.

The Doha Round was never really about development per se, even though it may have been marketed as such. But it is nonetheless true that developing countries as a group may be the biggest losers from the failure of the round. The Doha Round was christened the 'Doha development agenda', not because its purpose was to achieve policies that would stimulate development, but because it was intended to pursue the usual objective of trade liberalisation with the unusual proviso that developing countries would not be sidelined or put at a disadvantage.

Trade liberalisation may well be necessary for economic development, but it is hardly sufficient. The best that could have been expected from the Doha Round was therefore to remove barriers to development. Those barriers exist – and may continue to exist as a result of the Doha Round's failure – because developing countries have failed to participate in previous negotiating rounds where they might have pushed to open markets to their exports.

Instead, first because they were late to sign the General Agreement on Tariffs and Trade (GATT), and then later because they sought and were granted 'special and differential treatment' that made them exempt from the negotiations, they sat on the sidelines while developed countries negotiated downwards those trade barriers that it was in their mutual interest to eliminate. Developing countries benefited from these negotiations to some extent, as their 'most-favoured-nation' (MFN) status allowed them the same market access granted to others. But this was not usually in the sectors where developing countries themselves were most able to export.

As a result, developed countries now have their highest tariffs on goods exported by developing countries, both labour-intensive manufactures, such as textiles and apparel, and various agricultural products. The latter are also subject to significant subsidies provided by developed countries' governments to their agricultural interests.

In addition, because they did not participate actively in previous rounds, many developing countries also have high tariffs on numerous imports. If the Doha Round is not revived, this unsatisfactory state of affairs will continue, and the developing countries will continue to be hobbled in their efforts to escape

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poverty.

By remaining exempt from the negotiations, developing countries not only failed to secure the benefits of other countries' liberalisation for their exports. They also failed to secure the benefits from their own liberalisation, although some countries did, eventually, see these benefits and opted to liberalise unilaterally. But by avoiding the negotiated commitment to liberalise, they also avoided the international discipline that might have assisted them in achieving reforms of internal policies as well.

2 The trade interests of developing countries

Developing countries have a shared interest in exporting

The principal interest of any developing country in the context of trade negotiations is market access for its exports. Tariffs and other barriers to developing countries' exports have always been very restrictive and have prevented these countries from harnessing their comparative advantages to the cause of economic growth.

Indeed, it has been common for developing countries to seek to exploit a newly found source of comparative advantage, only to be met by new barriers to their exports as soon as these exports become large enough to be noticed by competitors abroad. In that sense, therefore, developing countries share a common interest: reducing trade barriers in the rest of the world, both developed and developing, against their exports.

But this shared interest is often illusory since developing countries are themselves diverse and export many different things, sometimes to each other. And when they export to each other, the interest in exporting conflicts with a second major goal that many developing countries profess (even though it is contrary to what economists view as being in their interest): restricting imports.

Very much like in the developed countries, where protectionist instincts have to some extent been whittled down through earlier rounds of trade negotiations, developing countries seek to protect their domestic industries even in sectors where other developing countries may have an advantage. When that happens, the export interests of the developing world come into conflict.

Fortunately, this divergence of interests is not as severe as it might be. In the realm of manufacturing, many developing countries tend by definition to be abundant in labour and to have their comparative advantage in labour-intensive goods such as textiles and apparel. This means that they compete with one another as exporters – a fact that may pose its own problems – but at least they have a shared interest in reducing barriers to the importing of such products in the developed world.

Developing countries' export interests are much more likely to diverge when based on something other than an abundance of labour, most obviously in agriculture or other natural resource-based industries. Here their interests tend not to be in direct conflict, in the sense that some import what others export, but rather that they care about different things. Thailand's rice exporters are unlikely to care very much about the barriers that Argentina's beef exporters face in the developed world.

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Furthermore, some natural resource products face little competition in the developed world and therefore face low trade barriers, while others are heavily protected. Getting oil-exporting developing countries to cooperate with exporters of both beef and rice may be difficult. But it may not be impossible, especially in the context of multilateral negotiations where broad reductions in trade barriers on many products are being considered simultaneously.

Competition among developing countries does not justify protection

A more serious conflict may arise not over what the developing countries are able to export, but over how much. The asymmetry in size between many small developing countries, on the one hand, and China and India on the other, leads the former to fear the effects of international competition in precisely the labour-intensive sectors where all of them export. The perception is that China, particularly, has so much cheap labour that other countries that are abundant in labour cannot possibly compete, especially now that China is a member of the WTO and is getting MFN treatment.

In fact, of course, China was already getting MFN treatment before it joined the WTO, and the increase in competition with China is more a by-product of its remarkable growth since making the transition to a market economy. And like other fears of international competition that have existed for two centuries, the fear of China is largely misguided and certainly overblown.

Small countries are already beginning to find that they can compete successfully in some products even as they may have to move out of others. The process of adjustment as comparative advantages evolve can of course be painful, but the view that countries cannot compete at all with China and India is surely false.

Some developing countries face erosion of preferences

Another conflict that may arise among the interests of developing countries stems from asymmetries in the policies they have faced in the past. In the presence of generally high barriers to their exports, some developing countries have prospered from special treatment by particular developed countries as markets for their exports. This preferential access has often been based on former colonial relationships.

As multilateral trade barriers have been reduced, and as negotiations proceed towards reducing them further, these countries see themselves losing their markets to other developed countries that were previously not favoured. Unlike competition with China, which may be more a problem of perception than reality, this problem is very real. The trade preferences enjoyed by members of the Lomé Convention, for example, have allowed high-cost industries to survive, and the extent of the preference is a measure of the cost disadvantage that they will experience when the preferences are removed.

This does not mean that these countries have no comparative advantage or ability to gain from trade. But it does mean that they are likely to have to transfer resources from the artificially favoured sectors to ones in which they can compete without the preferences, and that they will lose the benefits that the preferences provided.

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In some cases, the benefits from the preferences may have been wisely invested in the physical and human capital needed for these countries to move into other industries without preferences. But there is no doubt that there are other countries where this has not happened. For these countries, the failure of the Doha Round may be their only hope of continuing to live in the style to which they have become accustomed.

Developing countries can gain by cooperating

In sum, although the trade interests of developing countries are not by any means coincident, it does seem that many of them share sufficiently common interests in reducing trade barriers, at least in the developed world, that they should be able to cooperate to pursue that end. It is encouraging, therefore, that many of these countries were able to come together in what is now called the G20 at the Cancún ministerial conference in 2003, and that they have continued to cohere since then.

It is of course discouraging that they are resisting liberalisation of their own trade barriers, but that is also understandable. And perhaps it is too much to expect them to concede on this before they get a clearer signal from the European Union (EU) and the United States that their trade barriers and subsidies will be given up.

An alternative that has to be considered, especially if the Doha Round fails to restart, is for developing countries to pursue trade liberalisation by other means, most obviously via bilateral and regional trade agreements. The problem is that if such agreements attempt to harness common interests simply by the developing countries negotiating among themselves, they will fail to address the most severe impediment that they all face in international trade: protection by developed countries.

Alternatively, if they want to negotiate directly with particular developed countries, it is unlikely that the latter will willingly negotiate with them as a group. For example, although the Free Trade Area of the Americas was conceived by the United States as precisely such an arrangement, it has never made much progress, and most recently, the United States has seemed to prefer negotiating with individual developing countries (or with small groups, when the countries themselves are very small, as in Central America). That preference may be explained by a US desire for greater advantage in the negotiations so as to achieve objectives other than trade liberalisation.

It might well be very much in the interest of significant regional groups of developing countries to insist on negotiating with the EU and the United States *en masse*, precisely so as to undermine this advantage that the larger players wish to exert. But it seems unlikely that they will get agreement to do this, even among themselves, since the larger developed countries can offer incentives for them to negotiate separately.²

2 See Evenett (2005) for a model of how dominant countries can get smaller countries to compete for access to their markets.

3 The structure of trade negotiations

Developing countries have played only a small role in past negotiations

In the past, trade negotiations within the GATT and WTO have been conducted primarily between the largest negotiating blocs – the EU and the United States – with the eventual agreement then sold with minor modifications to the other participants.

Smaller countries might press for particular concessions, for themselves or for a like-minded group such as the Cairns Group of agricultural exporting countries, but in practice that did not usually achieve much. A smaller country might also play a larger role by acting as an intermediary between the EU and the United States, but that too gave only limited benefit. Whatever deal the EU and the United States reached, most countries had to 'take-it-or-leave-it' – and the pressure to take it became extreme.

Nonetheless, this somewhat understates the role of developing countries. Each of the many issues that enters a round of negotiations is considered within a negotiating group, which includes delegates from many more countries than just the EU and the United States. Developing countries do sit at the table in these groups, as they do in the 'green room' discussions that attempt to reach final agreement on particular issues.

These groups are assembled on a somewhat ad hoc basis by the WTO director-general, and some have viewed this process as inadequately representing the interests of developing countries. But the fact remains that a selection of them are at the table, expressing their views, and they certainly have had a non-trivial affect on the outcomes of the negotiations, if not a major one.

The 'development agenda' should provide assistance to liberalisation, not exemption from it

The official 'development' orientation of the Doha Round might be thought to represent an example of the developing countries' interests. In fact, however, it seems likely that the stress on development in the Doha declaration in November 2001 was more a reaction to the post-9/11 need by developed countries to accommodate others than any particular push by the developing countries themselves.

In any case, there is real question about the extent to which trade negotiations should have such an orientation. Previous rounds had created impediments to development by leaving developing countries on the periphery of the negotiations, and it is important that this be corrected.

But it is within neither the purview nor the expertise of trade negotiators to implement many of the changes that are necessary for poverty reduction and economic growth in developing countries. The best that they can do is seek to remove impediments. That is an important objective, but if it is advertised as solving the manifold problems of developing countries, it can only raise expectations that will be disappointed.

That said, it is worth asking whether the Doha Round should include a bias in favour of developing countries. The fact that previous rounds have arguably been biased against them, mostly by exclusion, may suggest that this would be appropriate. Unfortunately, such a bias would undoubtedly be interpreted as meaning

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that developed countries should make greater concessions than developing countries, lowering their own trade barriers and removing subsidies while developing countries do little themselves.

Economists know that such a bias is actually against the interests of developing countries and is really a bias in the opposite direction. Trade negotiations are about giving countries external incentives to implement painful but desirable policy changes that they would otherwise be unable, politically, to achieve. Seeming to 'favour' developing countries by exempting them from this process is not a favour at all.

The trick, therefore, is to find additional ways to address developing countries' interests without exempting them from trade liberalisation. This was the intent of the Doha declaration, which repeatedly identified developing countries for special assistance in implementing whatever agreements might be achieved. Unfortunately, the WTO lacks any mechanism to provide such assistance, and it is unclear how a completed Doha Round that included such promises would actually deliver on them.

From this perspective, renewed progress in the Doha Round may depend on initiatives outside the WTO to mobilise resources for assistance. A credible commitment by the EU, the United States and other developed countries, as well as by international financial institutions, to provide greater resources for implementing liberalisation in developing countries, might be just the incentive to get them to be more forthcoming in the negotiations. The aid for trade initiative is a step in this direction.

4 Options for the developing countries

Developing countries should act collectively to reinvigorate the WTO

Given that a successful conclusion to the Doha Round would offer great benefits to developing countries, the first option that must be considered is whether they can play a role in getting it back on track. The answer is surely yes, in that it has been their refusal to offer meaningful trade liberalisation that has led (along with stubbornness on the part of the EU and the United States) to the current impasse.

To reverse that, it will first be necessary for a number of major developing countries to recognise that trade liberalisation is in their interest. Economists' arguments to that end have largely fallen on deaf ears, or at least ones that are not very influential. The likelihood in the near term of greater understanding of the benefits, not just the costs, of reducing trade barriers is probably too small to count on.

Somewhat more likely would be a greater appreciation of the benefits to be had from liberalisation abroad, making it seem worth the cost of their own liberalisation. Indeed, the emphasis by the G20 and other developing country groups (such as the cotton exporting African countries) on the need to change developed countries' policies suggests that the costs of these policies are becoming better understood.

It may even be that the costs of these policies are being overstated: agricultural subsidies, after all, harm only those countries that are net exporters of the subsidised products, while they benefit those that are net importers.

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But if exaggeration of the costs can help to enhance the perceived benefits of liberalisation, perhaps to the point that the developing world is ready to 'pay' something to achieve it, then it may serve as a tool to unite those countries in a willingness to participate in the negotiations more constructively.

A final possibility is to rebalance the developing world's understanding of the relative gains from liberalisation for developed and developing countries. Understandably, the perception right now is that the greatest beneficiaries from liberalisation are the developed countries, especially their large corporations that are seeking to extend their reach into developing countries' markets. This perception is enhanced every time someone harangues the developing world for its failure to cooperate.

But in fact, the developed countries already enjoy most of the benefits from trade that they will ever achieve, and extending trade liberalisation to new markets will benefit them relatively little. By the same token, the multinational corporations do indeed seek to profit from selling in new markets, but the size of their operations in the developed world suggests that these benefits too, important as they may be, are relatively small.

In contrast, the developing world stands to gain far more from liberalisation, including their own. Their markets are small and seriously distorted in ways that international competition can readily correct. The trade barriers that they both impose on themselves and face from others cover a much larger part of their trade than these same barriers account for in the developed world.

For example, research on the North American Free Trade Agreement (NAFTA) shows that the economic gains to Mexico, as a share of its GDP, were an order of magnitude larger than the gains to Canada and the United States (Brown et al. 1992). So the perception that trade liberalisation is mostly of benefit to the developed world is simply wrong.

This matters, because many in developing countries are suspicious of entreaties from developed country governments for them to go along with trade negotiations, thinking that the motive is to benefit the rich not the poor. They may even be correct about the motive: many in developed countries probably do believe that their constituents will reap the lion's share of the benefits from liberalisation.

But that belief is incorrect. In fact, if the Doha Round never recovers and if trade liberalisation comes to a halt indefinitely around the world, the harm to the developed countries will be minimal. They have already achieved most of their gains from trade, and unless the process of liberalisation is actually reversed, they will be just fine. It is the developing countries that stand to lose most, by far, from this impasse.

This message needs to be conveyed to opinion leaders in developing countries. They must come to understand that the Doha Round is not primarily a game played by and for the people and corporations of developed countries. Rather, after half a century of trade liberalisation that sidelined developing countries, it is now a game that must include, and will primarily benefit, them. Indeed, if the round fails, there will be plenty of people in the developed world who will breathe a sigh of relief.

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All countries should encourage and cooperate in 'aid for trade' initiatives

In recent years, there has been a growing awareness that developing countries' participation in international trade is hindered, not just by the barriers put in their way by countries with which they might trade, but also by physical and institutional deficiencies within their own economies that make it difficult to export and import. Thus has grown the recognition that assistance to these countries should include 'aid for trade.'

As stated in a report from the International Monetary Fund (IMF) and World Bank (2005), aid for trade is 'provision of assistance by the international community to help countries address supply-side constraints to their participation in international markets and to cope with transitional adjustment costs from liberalisation.'³

Aid for trade is an explicit part of the Doha Round agenda, but if the round does not proceed, it is even more essential that aid for trade initiatives are pursued. The IMF and the World Bank are committed to providing such assistance, but as always, developing countries themselves need to play an active role in seeking this assistance and making sure that it is tailored appropriately to their needs.

Fortunately, this is one area where resistance to change ought to be minimal, since the benefits to developing countries are much easier to see than the benefits from trade itself. And even though aid for trade will lower the costs of trade if it succeeds (and thus have many of the same effects as tariff reductions), that fact may be less apparent to import-competing interests and thus not excite the same degree of opposition.

The bottleneck instead is likely to come from the aid providers, who bear its budgetary cost. Fortunately, there seem to be plenty of funded initiatives available both from the international financial institutions and from developed countries. What is needed now is for developing countries to submit well-conceived proposals for the use of these funds, and then to make sure that the projects are carried through.

Regional and/or bilateral arrangements are not optimal but often worth pursuing

The obvious alternative to multilateral trade liberalisation is for individual developing countries to enter into trade agreements with other countries or groups of countries. The current wave of regional trade agreements, which began with US negotiations first with Canada and then with Mexico to form the NAFTA, was itself in part a response to the failure of multilateral negotiations, progress on which was then stalled in the Uruguay Round.

Even though the Uruguay Round ultimately finished successfully, subsequent difficulties first in starting a new round at Seattle in 1999, and later in pursuing

3 The report goes on to list the following elements of aid for trade: 'technical assistance; capacity building; institutional reform; investments in trade related infrastructure; and assistance to offset adjustment costs, such as fiscal support to help countries make the transition from tariffs to other sources of revenue.'

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the negotiations of the Doha Round, have undoubtedly contributed to the willingness and often eagerness of almost every country in the world to enter into such agreements. Today, more than 200 of them have been notified to the WTO.

Economists are largely in agreement that such preferential trading arrangements are, at best, inferior to multilateral liberalisation, and that they have the potential to be distinctly harmful, even to their participants and certainly to outsiders. That makes it difficult to provide guidance on the form that such agreements should take. Nonetheless, if multilateral liberalisation turns out not to be an option, then many developing countries will undoubtedly take the preferential route.

Developing countries should choose their partners carefully

If developing countries do pursue preferential trading arrangements, they must decide on what kinds of potential partner with which to negotiate. An obvious choice is to form free trade agreements (FTAs) with their neighbours. The economic case for doing so is not clear, but given the desirability of making and/or maintaining peace with one's neighbours, then such regional trade agreements probably make most sense.

Another choice of partner for some countries is between developed countries on the one hand, and other developing countries on the other. The problem with FTAs among developing countries is that they are likely to involve competing exporters of many of the same products. This means that the potential for trade among them is either minimal or likely to be particularly disruptive.

It is true that there are also similarities in trade patterns among developed countries that have successfully pursued economic integration, especially in the EU. But there what appear to be common industries in fact often produce differentiated products, and there is ample scope for intra-industry trade. Such trade seems much less likely within FTAs among developing countries, which tend to find their comparative advantages in more standardised products.

This suggests that developing countries might be better advised to seek trade agreements with developed countries, such as the EU or the United States, as indeed a great many of them are currently doing. In terms of the economics of trade alone, this seems a fruitful approach, since it opens import-competing industries in both parties to competition from comparative advantage-based exports, but does so in a smaller way than might be feared from multilateral liberalisation. Indeed, such agreements may lead these import-competing industries gradually to shrink, thus over time reducing the resistance to broader liberalisation.

The downside of such arrangements is the extreme asymmetry between the two sides that negotiate them, one rich and the other poor. This would not matter if FTAs consisted simply of reducing all tariffs to zero among themselves and nothing else. But FTAs are never that simple. In addition to troublesome rules of origin, they typically carry all sorts of other baggage to protect labour and environmental standards, intellectual property rights, investment and much else.

These additional features of an FTA are not necessarily undesirable, but sometimes they can be. And whether desirable or not, they usually operate in only one direction, constraining or requiring change in the policies of the developing country partner without any extra expectations at all of the developed country partner.

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Thus, even though in principle trade agreements should be able to yield substantial net positive benefits for both parties, this asymmetry is likely to mean that the developing country partner is pushed to the lower limit of the benefits that it will accept, with the larger share going to the developed country.

While developing countries often fear that multilateral trade liberalisation will primarily benefit the developed world, for tariff liberalisation at least, that fear is unfounded. But when agreements extend well beyond the setting of tariffs into many other issues – as they do in FTAs even more than in the multilateral system – that fear may well be justified. Indeed, it might be suspected that some of the recalcitrance on the part of developed country negotiators in the Doha Round may be intended to assure exactly that outcome.

Free Trade Areas should be structured to approximate multilateral free trade

FTAs will continue to be negotiated between developed and developing countries. So how they can be constructed so as to be most beneficial, or least harmful, to the developing country partners? The answer is to approximate, as closely as is possible within an FTA, the benefits of multilateral free trade:

- This means that, first, when overlapping FTAs are formed, with countries A and B both forming FTAs with country C, then they should more or less automatically form an FTA between A and B as well. Without that, country C – which is often a developed country – gets to play the other two countries off against each other while being immune to such gaming itself.
- Next, when A, B and C form FTAs of A&B, A&C and B&C, they should specify the rules of origin of each bilateral FTA to allow the accumulation of content from each of the three countries. Thus, if each of the bilateral FTAs requires, say, 30% local content to qualify for tariff-free access, then that 30% should be calculated to include content from all three countries.
- Once that is done, if the FTA is no more than a trade agreement, it would make most sense to redefine it as a single FTA encompassing all three countries. Unfortunately, trade agreements are never this simple, and their other features may provide impediments to merging them, and even incentives not to do so. Developing countries should vigorously resist such features that cannot be easily extended to new members, as these are likely to be used as leverage against their interests by the more dominant partner.

All of this advice is intended not just to allow FTAs to approximate multilateral free trade as far as possible, but also to smooth the transition towards that ideal over time. It is likely to be a vain hope, but GATT Article XXIV should be revised to require FTAs always to permit new entrants under the same conditions as existing members. That would ensure that FTAs make it easier, not harder, for regions

Reviving the Doha Round: The Agenda for the Developing Countries 45**Table 2.1** Welfare effects of bilateral negotiating options for the United States and Japan (billions of dollars)

United States and...	United States	Partner	Other	Global
Australia	19.4	5.4	-1.7	23.1
Central America and the Caribbean	17.3	5.3	-6.9	15.7
Chile	6.9	1.2	-0.2	7.9
Morocco	6.0	0.9	0.6	7.5
Singapore	15.8	2.5	4.2	22.5
Southern African Customs Union	9.6	2.2	0.0	11.8
Thailand	17.1	5.6	-0.8	21.9
Free Trade Area of the Americas	67.6	45.4	-3.6	109.4
Japan and ...	Japan	Partner	Other	Global
Chile	2.8	0.9	-0.2	3.5
Indonesia	10.7	1.7	-1.3	11.1
Korea	18.7	2.2	-1.2	19.7
Malaysia	10.5	0.3	-0.7	10.1
Mexico	8.2	3.3	-0.9	10.6
Philippines	2.2	0.5	0.3	3.0
Singapore	5.0	0.6	1.1	6.7
Thailand	19.5	-0.5	-5.5	13.5

Source: Brown et al. (2006).

of free trade to expand.

Unfortunately, such a requirement would not be on the table for discussion even if the Doha negotiations were proceeding. And those who negotiate FTAs are unlikely to impose it themselves, since members of FTAs always value the exclusivity of market access that their arrangement provides.

All is not lost, however, even if bilateral and regional trade initiatives do become the dominant form of liberalisation at the expense of further multilateral negotiations in the WTO. A lively debate has raged among economists between those who see regional liberalisation efforts as 'stepping stones' towards multilateral free trade and those who see them as 'stumbling blocks' (Bhagwati 1991). This debate has merits on both sides, but it does seem clear that even though regionalism is distinctly inferior to multilateralism if it fails to lead to multilateral free trade, it seems to be moving the world in the right direction.

Brown et al. (2006) and other research cited in that study report calculations of the effects of a considerable variety of FTAs, almost all of which yield net benefits to the world as a whole. Table 2.1 shows a sample of the calculated welfare effects of FTAs formed by the United States and Japan with various trading partners on the participants, the rest of world and the world as a whole. In all cases, the global effects are positive because the benefits to the participating countries far outweigh the (often negative) effects on outside countries.

Initiatives in particular industries are of limited benefit to developing countries

An alternative to negotiating broadly over many categories of trade but with a single country or a small group is to negotiate narrowly over trade in a single industry, perhaps with a larger group. Developed countries have pursued this strategy,

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often successfully, as they have struck agreements over such industries as aircraft, finance and telecommunications. Developing countries could conceivably do the same.

Certainly, if developed countries do initiate such discussions, it may well be in the interests of developing countries to participate. But for most industries, it seems unlikely that developing countries themselves could initiate such negotiations, except perhaps if an industry were of interest only to developing countries, both as exporters and as importers. It seems doubtful though that many such industries may exist. There is therefore not much potential for a sectoral approach initiated by developing countries.

This leaves the question of whether developing countries should participate in sectoral negotiations initiated by developed countries. This idea should be treated sceptically. Such negotiations are bound to occur only in sectors where the developed countries have interests as exporters. This works fine among themselves, where with intra-industry trade, they often can strive to open each other's markets within the same sector. But developing countries seldom are in this position. If they participate in such negotiations, unless they merely act to block agreement, they will be pushed to open their own markets without getting anything in return.

This is not to deny the benefits to developing countries of opening their markets to foreign exports in any sector. But if such sectoral negotiations proceed outside more comprehensive multilateral negotiations like the Doha Round, they will inevitably lead to access for the developed world to the markets of developing countries, but not the reverse. That is too close to the current situation, in which after 50 years of trade rounds, developing countries still play little role. It would be better, therefore, if they limited their negotiations to ones where trade-offs across sectors are possible, either multilaterally or bilaterally.

Developing countries with high protection will gain from unilateral liberalisation

For the same reason, unilateral liberalisation should be treated with scepticism in some cases and by some countries. It is not that unilateral liberalisation is not beneficial; it surely is, as two centuries of international trade theory have convincingly established. But if done alone, unilateral liberalisation generates only the benefits from itself, not from any foreign liberalisation that could have been secured in exchange through negotiation.

For small countries, that does not matter. Their markets are not large enough for anyone (except possibly a close neighbour) to be willing to pay anything for market access. Even for large but very poor countries, that may be true as well. But as some of the larger developing countries have made economic progress, and especially as they have begun to join together for negotiating purposes, their levels of protection have become bargaining chips for which they should be able to get something in return.

Of course, if their tariffs are very high, then the harm that they do before they are negotiated downwards is too costly to justify hanging on to them. Countries with very high tariffs certainly should reduce them substantially and unilaterally, especially if negotiations for reciprocal liberalisation do not seem to be forthcoming.

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But once their tariffs are down to a modest level, there is a case for keeping them in place as long as their exports face protection abroad. Without that, they may never be able to get those foreign tariffs removed.

5 Conclusion

Looking at the various options, it is clear that the most desirable alternative from the perspective of developing countries would definitely be for the Doha Round to be restarted and for it to proceed to a successful conclusion. But as time passes, this option seems less and less likely to happen, unless the US president's negotiating authority is extended beyond mid-2007.

But no progress will be made as long as developing countries continue to insist on offering nothing in exchange for the policy changes that they seek in the developed world. They simply must accept that substantial trade liberalisation is in their own interest, if not for the sake of the gains from trade that economists universally tout, then for the sake of the policy changes that they seek abroad.

If they were to come to the negotiating table offering significant market access to developed countries' exporters, that might mobilise those exporters to push their own governments to be more forthcoming in the ways that everyone agrees would benefit developing countries – reducing subsidies and tariffs on developing countries' exports. Without such an offer on the table, it is only the protected and subsidised interests in the developed world that are paying attention to the negotiations, and they are successfully blocking any progress.

Of the other options, the provision of aid for trade should certainly be favoured, whether or not it is done within the context of the Doha Round. But useful as aid for trade certainly is, it will never even begin to serve as a substitute for real liberalisation of policies that distort trade in both the developed and developing worlds.

If the Doha Round does not restart, then bilateral and regional initiatives are often worth pursuing. Although not guaranteed to be beneficial, these initiatives do by and large seem to have moved the world in a positive, albeit very messy, direction. But their terms should be better designed so that they are more likely to lead down a path towards more liberalisation rather than less.

And finally, with or without the Doha Round, very small countries and those with high tariffs should reduce them unilaterally. The harm they are causing to their own economies exceeds whatever benefits they may perceive for the beneficiaries within their countries. This is also too high a cost to pay for negotiating chips that may, some day, buy them concessions abroad.

But large developing countries with tariffs that are already low or moderate should postpone reducing them further. They should also join together as far as possible, and they should then offer to eliminate these tariffs in exchange for whatever liberalisation they can elicit from developed countries, either individually or *en masse*.

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3 Services: A 'Deal-Maker' in the Doha Round?

Philippa Dee, Australian National University
and
Christopher Findlay, University of Adelaide

Progress in the Doha Round of trade negotiations requires leadership – not just from the negotiators at the World Trade Organisation (WTO) but also from the national capitals where trade policy strategy is constructed. This chapter focuses on the weight that policy strategists might put on services and the manner in which services negotiations should be treated.

There have been reports that 'services demandeurs [the countries making requests] such as the US, the EU, and Japan... emphasise in Davos that services trade is a critical component of the overall market access negotiations' and that they have called on other WTO members to put more effort into 'fleshing out commitments in services trade'.¹ This reinforces the value of an examination of how services might be treated.

To date, trade negotiators have been stuck on the more familiar territory of issues concerning goods markets. As a result, they have let services negotiations become a hostage to negotiations in agriculture. The lack of progress in the latter may be an excuse, but it has also probably come as a relief to services negotiators. They would, in any case, be constrained by other concerns about the potential effects of freeing up services trade and investment.

To some extent, these concerns relate to the non-economic implications of services reform and the 'rules' applying in services transactions. These were among the topics of a 'mini cluster' of services meetings held in the last week of February 2007.

But while disciplines on domestic regulation, subsidies and government procurement are important, they are not a fundamental issue. Nor is the concern with how to preserve non-economic objectives in policy-making, given that a continuing 'right to regulate' and a 'carve-out' or exemption of public sector services have been acknowledged.

It is more likely that the main issue of substance – at least for the developing countries – is the lack of capacity to respond to domestic political concerns about foreign penetration and establishment of operations in local services markets. These also contribute to demands for 'safeguard' mechanisms.

There has been a lack of progress in services despite the demonstrable gains that would arise from services reform. In that sense, negotiators have cut themselves loose from their national interests. A reorientation is now critical.

1 *Bridges Weekly Trade News Digest* 11:2 (24 January 2007) and 11:4 (7 February 2007).

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At the same time, with the slow progress being made in the WTO, negotiators have embarked on a series of bilateral and preferential trade agreements (PTAs). Through these channels, they have been able to offer their political masters a new portfolio of their services. Since these preferential negotiations have proliferated, they also demand attention, and their interaction with the WTO process has to be explored, particularly with respect to services.

This chapter offers a framework for dealing with the main sticking point: the concern about foreign participation in local services markets. It argues the case for taking a wider view of reform, rather than simply focusing on the conditions of foreign entry, a perspective that has blocked progress to date.

This perspective leads to specific recommendations for the application of WTO processes to services reform, and to a strategy for the treatment of services in the negotiations, including their relationship to negotiations in other sectors.

Sections 1 and 2 examine the nature of services trade barriers and the empirical evidence on their impact. The main interest is in services traded across borders or via the establishment of an operation in another country.² Section 3 examines the prospects for services negotiations in the Doha Round, concluding that:

- Services is not likely to be a 'deal-maker' in the WTO – but nor is it a good idea for services to break away from the 'single undertaking' principle (currently understood to require all WTO members to sign up to all new agreements) and 'go it alone', despite the superficial appeal of this option.
- It is important to recognise that the big gains from services reform are in market access and especially domestic regulation, not in national treatment.
- The main value of using the WTO framework is to further the domestic reform agenda of each country.

The chapter therefore ends with the observation that 'the question is not what services can do for the WTO and its negotiations, but what the WTO and its principles can do for services reform.'

1 The nature of services trade barriers

When services are traded, the transaction typically occurs 'behind-the-border', through a foreign establishment or a transaction with a visiting consumer. Even when cross-border trade takes place via e-commerce, it is not easily observed by customs officials.

So how does protection work in the services sector? Such transactions are not amenable to border protection. Instead, services trade barriers are typically

² There are many important issues associated with the movement of people, but these issues impinge on immigration policy as much as on services trade policy, and should probably be addressed as such.

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behind-the-border, non-price regulatory measures. These may be of two types:

- They may specifically discriminate against *foreign* suppliers – either against their entry or against the nature and scope of their operations once they have entered the market.
- They may protect incumbent service providers by discriminating against all new suppliers, be they domestic or foreign – either by restricting entry or by restricting the nature and scope of new entrants' operations.

The General Agreement on Trade in Services (GATS) under the WTO recognises that services trade barriers need not be discriminatory against foreigners. It recognises a specific list of (mostly quantitative) restrictions on market access that are not discriminatory, and are to be the subject of negotiation.

Many research studies on the effects of services trade barriers have extended the definition of market access to cover all measures that are non-discriminatory (for example, Findlay and Warren 2000). The GATS also recognises 'derogations from national treatment', meaning discriminatory restrictions.

Thus, a key feature of services trade barriers is that they often protect incumbent service suppliers from any competition, be it domestic or foreign new entrants. This has implications both for the economic effects of services trade liberalisation, and for the political economy of services trade reform.

Services are also an area where market failures can occur. For example:

- 'Natural monopoly' is a characteristic of some network industries: it may be economically inefficient to have key 'bottleneck' facilities provided by more than one service provider, so regulation is required to prevent the abuse of this monopoly power.
- 'Information asymmetry' is almost by definition a feature of professional services: the client is not in a position to judge whether the service being delivered is of reasonable quality, so licensing or accreditation requirements can help to bridge the information gap.
- Similarly, there is a legitimate role for prudential regulation of financial services to ensure systemic stability, and for safety regulation in air passenger transport.

The GATS recognises the right of individual governments to regulate: non-economic objectives can be pursued, for example, through universal service obligations; and services provided by governments can be quarantined.

But the GATS also requires that domestic regulatory regimes be the 'least burdensome' necessary to achieve their objectives. This provides a further WTO discipline on non-discriminatory measures that fall outside the narrow scope of GATS market access commitments, although the discipline is rather loose, especially since the definition of 'least burdensome' has yet to be decided by WTO members.

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While services are typically not protected by tariffs, services trade barriers may or may not be tariff-like, in the following sense. Some regulatory trade restrictions, particularly quantitative restrictions, create artificial scarcity. The prices of services are inflated, not because the real resource cost of producing them has gone up, but because incumbent firms are able to earn economic 'rents'. These are akin to a tax, but with the revenue flowing to the incumbent rather than to government.

Liberalisation of these barriers would yield relatively small gains associated with better resource allocation, but they would also have redistributive effects associated with the elimination of rents to incumbents. Such rent-creating restrictions are tariff-like, with the redistribution of rent having effects similar to the redistribution of tariff revenue.

Alternatively, services trade restrictions could increase the real resource cost of doing business. An example would be a requirement for foreign service professionals to retrain rather than pass an accreditation process when they have relocated to a new country.

In this case, liberalisation would be equivalent to a productivity improvement (saving in real resources), and yield relatively large gains. This could increase returns for the incumbent service providers, as well as lowering costs for users elsewhere in the economy.

To understand the economic effects of services trade barriers, and to work out policy priorities, it is therefore critical to know three things:

- The 'height' of the trade barrier – the equivalent of the tariff rate in goods trade.
- The 'incidence' of the barrier – whether it applies only to foreign suppliers or also applies to domestic operators.
- The 'impact' of the barrier – whether the barrier has created rents or raised real resource costs.

There is a growing body of research devoted to the first two aspects, but less clarity on the third.

2 **The empirical evidence on services trade barriers**

Tariffs come with ready numbers attached – the tariff rate is the height of the trade barrier. For services, things are not as simple. Measurement methodologies have needed to take account of the nature of services themselves.

Services are highly differentiated. Not only do they differ from one firm to the next, they also differ from one customer to the next. As Ethier and Horn (1991) note, what makes services special is that they are customised to meet the needs of individual purchasers.

This has meant that the measurement of services trade barriers cannot assume services are homogeneous. Nor is it appropriate to use the price comparisons methodology often used to measure non-tariff barriers in goods trade, since this assumes homogeneity across borders. Strictly speaking, it is not even appropriate

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to talk about a 'tariff equivalent', since this concept first assumes that services are primarily traded cross-border, and second, it often also assumes that the domestic and foreign service are perfect substitutes.

Because services trade barriers operate behind-the-border, research has typically quantified the effects of services trade barriers on some behind-the-border measure of economic performance. And because the counterfactual is unobservable, econometric techniques have been used to construct the counterfactual – what domestic prices or costs would have been in the absence of the services trade restrictions. Dee (2005a) provides a thorough review of the methodologies and results to date.

The height of the barrier

In some services sectors, particularly banking and telecommunications, services trade barriers are typically much higher in developing than in developed countries. In most cases, the remaining barriers in the developed world are low or negligible.

In other services sectors, particularly the professions, the distribution sector (wholesale and retail trade) and electricity generation, the barriers still tend to be higher in developing countries than in developed countries, but the barriers in the latter are often non-trivial:

- Particular developed countries have maintained high barriers to entry and operations in the professions, particularly the accounting and legal professions.
- Some have maintained significant restrictions on the operations of large wholesale and retail chains, either directly or through restrictions on zoning and hours of operation, to protect local 'Mom and Pop' stores.
- Trade barriers are also non-trivial in those developed countries that have yet to open their electricity generation sectors fully to competition.

In some sectors, barriers are as high in the developed world as in the developing world. For more than 50 years, air passenger transport has been governed by a system of bilateral air services arrangements, largely outside the multilateral framework of trading rules. The bilateral system developed because international air flights require international cooperation to provide the necessary infrastructure and air traffic rights. But the bilateral system has also created various limits on competition and trade in aviation services.

Some economies have recognised the costs of these restrictions in terms of higher costs and prices, and substantially liberalised air service arrangements, or made commitments to do so. There is now an 'open skies' arrangement within Europe, between the United States and a number of partner countries, and increasingly elsewhere. But on bilateral routes still governed by traditional air services agreements, the restrictions are as high for developed as for developing countries.

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For a few services sectors, the barriers are higher in at least some developed countries than in some developing countries. Maritime is a prime example. The United States maintains stringent cabotage restrictions, exempts liner shipping conferences from the normal disciplines of competition policy, and maintains a range of other restrictions, including on hiring foreign crews and on shipping non-commercial cargoes. Its trade barriers in maritime are estimated to be higher than in Latin America and most of Asia (McGuire et al. 2000).

Given these services trade barriers in developed countries, it is perhaps no coincidence that air passenger transport is carved out of the GATS, while maritime is an area where negotiations have tried and failed.

The incidence of the barrier

There is more variability among both developed and developing countries in whether barriers discriminate against foreign services providers or also affect domestic operators:

- In particular sectors, some developing countries maintain high barriers that are also strongly discriminatory against foreign operators, for example, banking in Malaysia and telecommunications in Thailand.
- In other sectors, barriers are lower but also strongly discriminatory, for example, banking in Thailand.
- In other countries, barriers tend to be both lower and less discriminatory, for example, the banking and telecommunications sectors in Russia, the Baltic states and much of south eastern Europe.
- In the developed world, trade barriers in banking and telecommunications are sufficiently low on average that any margin of discrimination is also trivial. At the other extreme, barriers in maritime are both high and discriminatory (see Figures 3.1 and 3.2, and Dee, 2005a).
- In Europe, the trade barriers in engineering services tend to be non-discriminatory, while those in legal services can be highly discriminatory.

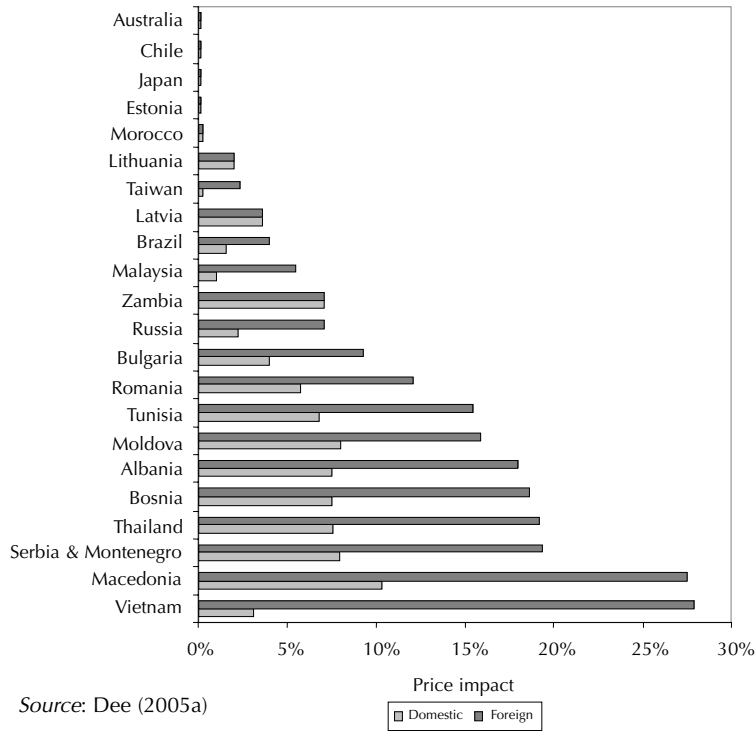
The one generalisation that can be made is that when there are significant barriers to foreign supply, there are typically also non-trivial barriers to domestic supply. It is very rare to have a significant barrier to foreign entry and/or operations with no barrier affecting domestic new entrants.

The impact of the barrier

A critical determinant of the projected gains from services trade liberalisation (and the policy priorities that flow from that) is whether the trade barriers are seen as affecting mark-ups or real resource costs. In modelling applications (e.g., Dee and Hanslow, 2001; Dee et al, 2003; Dee, 2005b; and Copenhagen Economics, 2005), this 'treatment effect' can dominate the estimated height of the trade barrier.

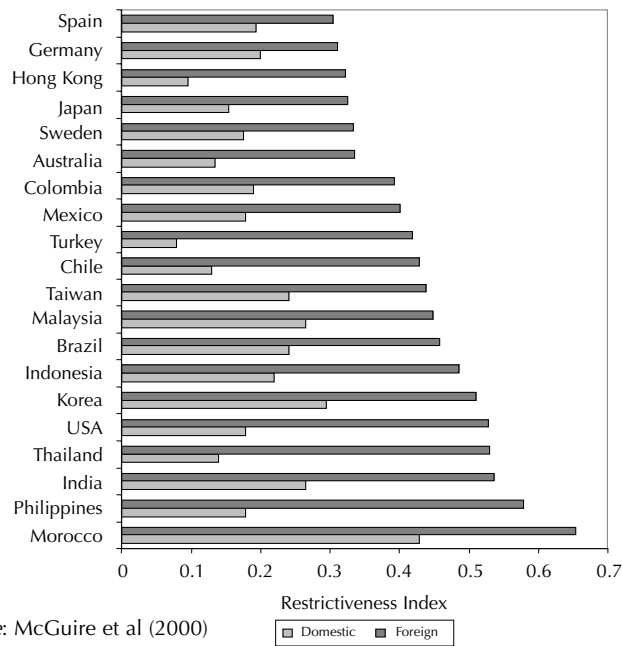
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Figure 3.1 The price impact of trade restrictions for domestic and foreign players in telecommunications



Source: Dee (2005a)

Figure 3.2 Index of trade restrictions for domestic and foreign players in maritime trade



Source: McGuire et al (2000)

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Whether barriers create rents or add to resource costs is severely under-researched. In some cases, the empirical evidence is suggestive, but not conclusive, because only one performance measure has been used. In other cases, a price impact is estimated, and then it is simply asserted whether the effect operates through price-cost margins or through real resource costs.

Theory can provide some guidance. Rents are likely to be created by quantitative and other barriers that limit entry (or exit, though this is far less common). Some 'red-tape' measures may add to resource costs. There are also many ways in which rents can be dissipated or capitalised. So non-tariff barriers that may once have been rent-creating for the initial incumbent become cost-escalating for subsequent incumbents.³

The limited empirical evidence tends to accord with this intuition.⁴ In banking and telecommunications, where explicit barriers to entry are rife, barriers appear to create rents. In distribution services, where indirect trade restrictions also apply, barriers appear to increase costs. In air passenger transport and the professions, barriers appear to have both effects. And theoretical arguments suggest that barriers in maritime and electricity generation primarily affect costs.⁵

3 Prospects for services negotiations in the WTO

Before turning to specific aspects of the WTO services negotiating processes, it is worth reviewing the rationale for a multilateral approach. One economic reason for negotiating services trade barriers multilaterally rather than liberalising them on a unilateral basis is if there are benefits from reciprocity within the services sector – a country gains more if other countries also liberalise their services sectors than if it 'goes it alone'.

One reason for there to be benefits from reciprocity within a sector is to offset adverse terms of trade effects (Bagwell and Staiger 1999). In goods trade, while tariff liberalisation will provide gains in allocative efficiency, it can also generate a terms of trade loss. So while the world as a whole would be better off, individual countries may not be. Reciprocity creates a countervailing terms of trade effect in the other direction, making it more likely that all countries unambiguously gain. This is the economics underlying the 'mercantilist' approach to goods trade negotiations in the WTO.

But since services trade barriers operate behind-the-border, services trade reform has its first round effect primarily on domestic prices and costs. If at least some of the barriers are cost-escalating, the resource savings from liberalisation are likely to dominate any direct terms of trade effects. And research suggests that services trade reform can often yield an indirect terms of trade gain, rather than a loss (for example, OECD 2004). So the case for reciprocity within the services sector is far less strong than it is for goods trade.

3 For example, Kalirajan (2000) provides indirect evidence that some of the zoning and other restrictions in the wholesale and retail sector have created rents that are subsequently capitalised into the price of commercial land.

4 Grogan and Johnson (1999); Kalirajan et al (2000); Kalirajan (2000); Nguyen-Hong (2000); OECD (2005); Copenhagen Economics (2005).

5 Steiner (2000); Clark et al. (2004).

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This is not to deny that there might be important political economy benefits from proceeding multilaterally. A key benefit from undertaking reform under the multilateral disciplines of the WTO is that the formal bindings provide protection against the risk of policy reversal. So even the current status quo offers have value. Furthermore, it is argued that the additional pressure from abroad can help countries to overcome domestic political constraints on reform. But in the area of services, other countries may make demands that are not in the reforming country's best interests.

Are there benefits from reciprocity across sectors?

Although the economic case for taking a multilateral approach to services trade negotiations in the first place is weak, services could still be a deal-maker in the Doha Round. This would require there to be benefits from reciprocity across sectors – countries gain more (or lose less) from liberalising their agriculture and/or manufacturing sectors if services sectors are also liberalised.

One economic reason for there to be benefits from reciprocity across sectors is that by spreading reforms widely, the resulting pressures for structural adjustment can offset each other. The expectation is that services trade reform will lower input costs for agricultural producers in the European Union, cushioning their adjustment costs associated with reductions in agricultural support.

This argument presupposes that if services trade barriers were reduced, then resources would be released from the services sector to be used elsewhere, including in agriculture. This is the basis on which agriculture's own structural adjustment problems would be eased.

If services trade barriers were tariff-like and discriminatory, then a domestic services sector could be expected to shrink as its trade barriers were removed. But if trade barriers also include non-discriminatory barriers affecting any new entrant, then the domestic import-competing industry can be too small, not too big.

Liberalisation can encourage additional entry by either wholly domestic firms or foreign multinationals into domestic production, and this can offset additional competition from cross-border trade, to the extent that this is also a feature of the market. Where heavily impeded cross-border trade is relatively unimportant (as Mattoo and Wunsch (2004) argue is the case for many services), the size of the domestic industry can be bigger after liberalisation than before.

A second reason why a services sector may grow in size when services trade barriers are liberalised is that, according to most input-output tables, the most intensive users of services are other services sectors, not agriculture or manufacturing (Dee et al. 2003, OECD 2004). For example, there are typically more telephones in office buildings than in factories.

Modelling results tend to show that the biggest output gains from services trade reform are within the services sector. Anecdotal evidence is also beginning to support this proposition. Members of the Australian Services Roundtable, a newly-formed services industry lobby group, have observed that their biggest customers are also Roundtable members, and they are increasingly seeking liberalisation of services sectors overseas to lower their own input costs, rather than to gain market access.

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In summary:

- Comprehensive services trade liberalisation is unlikely to ease the adjustment pressures associated with agricultural or manufacturing trade liberalisation.
- Hence the economic case for services to be a deal-maker in the Doha Round is weak.

Does this mean that services should break away from the single undertaking and 'go it alone' in the WTO? This is the inclination of some services trade negotiators who are frustrated at being held hostage to the negotiations on agriculture.

Some commentators have argued that this approach is not likely to yield much, since the 'ongoing' services negotiations that took place prior to the launch of the Doha Round (an earlier example of a stand-alone approach) yielded little. This comparison is probably unfair. It is likely that services industry groups in many countries are now much further up the learning curve, with a better appreciation of where their negotiating interests lie, and are now better able to articulate their interests through the trade negotiations than they were before.

But more recent experiences with services trade negotiations hint at something more fundamentally wrong. Following the 2005 ministerial conference in Hong Kong, there was a flurry of activity in the first part of 2006, as services trade negotiators convened for 'plurilateral' market access negotiations, a break from the more traditional bilateral request-and-offer approach. The talks were described as 'extremely positive' by Hamid Abdel-Mamdouh, the director of the WTO's services division.

Yet the reasons for the positive assessment were telling. The demandeur countries were pleased that the negotiations on the collective requests were not as contentious as many had feared. And some of the members that received requests felt they had been able to take advantage of the plurilateral approach to strengthen 'defensive' stances in areas where they were reluctant to increase their commitments to liberalisation. This prompted one observer to call the plurilateral approach a 'toothless process'.⁶

Such reactions suggest that members see the services negotiations as a 'zero-sum game' – where what is a gain for one side must be a loss for the other – rather than a positive-sum game with the potential for a 'win-win' outcome. So long as this is a common view, then questions about whether services should go it alone or whether negotiations should be bilateral or plurilateral within the WTO framework are second-order questions.

The perception of the negotiations as a zero-sum game arises from a preoccupation with national treatment in services trade negotiations, rather than market access or domestic regulatory reform. But until this fundamental imbalance is addressed, there would be little use in services breaking away from the single undertaking and going it alone, despite the superficial appeal of this option.

6 *Bridges Weekly Trade News Digest* 10:13 (12 April 2006).

Are services negotiations a zero-sum or positive-sum game?⁷

It is worth examining the evidence from services trade negotiations in PTAs since, in the absence of progress in the WTO, this is where services trade negotiators have been plying their trade. While many PTAs go further than the GATS, they have tended to be selective in two important ways:

- They have tended to be preferential, even in the provisions that go beyond goods trade.
- They have tended to target only those provisions that explicitly discriminate against foreigners.

There are strong political economy explanations for both of these outcomes.

With some exceptions, recent PTAs have tended to do one of two things in new areas like services – either bind the status quo or make concessions on a preferential basis, even when logic suggests they could sensibly be made non-preferentially.⁸

One very clear reason for this outcome is that countries with strong 'offensive' interests in the Doha Round are unlikely to give away negotiating power by making defensive concessions on a non-preferential basis within a PTA, prior to a Doha Round settlement. This reason for selectivity need not apply in the WTO itself. But other reasons for selectivity apply in both forums.

Partly because they have been preferential, recent PTAs have tended to target only those provisions that explicitly discriminate against foreigners. This is because, in many cases, the only provisions that can feasibly be liberalised on a preferential basis are those that discriminate against foreigners.⁹

But even without this feasibility constraint, there are economic and political economy forces that tend to limit concessions within PTAs to those that explicitly discriminate against foreigners. The central one is the threat to sovereignty that is felt most strongly by countries when contemplating making reforms to non-discriminatory domestic regulatory regimes as part of a trade agreement. To many countries, both developed and developing, this may be viewed as too much of a threat to the 'right to regulate'.

Negotiating 'modalities' have also contributed a focus on provisions that explicitly discriminate against foreigners, not just in PTAs but also in the WTO. The request-and-offer modality is currently being used in the Doha negotiations on services, and is the means by which many PTAs are negotiated.

Under this modality, countries are asked to contemplate, not just reforms that are in their own best interests, but reforms that are in their trading partners' best

⁷ Parts of this section are taken from Dee (2005b).

⁸ For example, two of Australia's concessions in the Australia-United States free trade agreement were the lifting of Foreign Investment Review Board screening on inward foreign direct investment in non-sensitive sectors, and a commitment to provisions similar to those in the WTO agreement on government procurement. Both measures were made preferentially, even though the arguments advanced by the Australian government would have applied a fortiori to non-preferential liberalisation.

⁹ The converse does not hold. Because some provisions do discriminate against foreigners, it does not mean that they can be liberalised on a preferential basis. For example, when countries lib-

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interests. It will tend to be in a trading partner's best interests to target only those provisions that explicitly discriminate against foreigners – in this way, the foreign market share is maximised. Foreign producers would generally have little interest in unleashing competition from promising domestic new entrants. (They would rather join a cartel on a far more selective basis.) And in these circumstances, the liberalising countries risk simply handing monopoly rents to foreigners. Indeed, this is the basis of the East Asian desire to have safeguard provisions in services negotiations.

A final consideration is one of visibility. Regulatory regimes are always complex, and often not very transparent to insiders, let alone outsiders. The regulations that will tend to be visible to potential foreign entrants are those that discriminate against foreigners.

But this focus on measures that discriminate against foreigners means that PTAs are not concentrating on the trade barriers that matter most in an economic sense. Dee (2005b) shows that the gains from such PTAs are small compared with a moderately successful completion of the Doha Round. And they are trivial compared with a comprehensive programme of unilateral regulatory reform, one that targets non-discriminatory behind-the-border restrictions on competition.

What then is the source of the interest in PTAs? A major motivation by demandeur countries is to capture 'first mover' advantage. Given the nature of services production, with its large sunk costs, first movers have a significant advantage. Mattoo and Fink (2002) compare the effects of 'sequential entry' to 'simultaneous entry'. A PTA negotiation might give a first mover advantage to a supplier who is not competitive in world terms. The country giving the preference risks landing itself with a second-class supplier that is difficult to budge. No wonder service negotiations are seen as zero-sum.

So what should happen with services?

The big gains in services are from reforming the non-discriminatory restrictions on competition that affect foreign and domestic new entrants equally. This is best done domestically, where a debate can be held about how any losses to incumbents can be managed politically. The important political economy considerations are about incumbents versus new entrants, not domestic versus foreign.

Negotiators' fundamental concerns may be the impact of rapid foreign entry into their markets. Such concerns are understandable if rapid entry occurs as a result of the removal of impediments to foreign firms while domestic incumbents remain constrained.

So what should happen with services is transparency in the first instance, followed by review and evaluation, and then domestic reform. This work can be undertaken whether or not the current round of negotiations proceeds. But it will be more effective if the work is embedded in the negotiations.

Given the complex nature of the policy barriers, transparency (that is, documenting existing policy) is an important first step. In some developing economies, even this task will be prohibitively complex and costly in terms of bureaucratic resources. So there will be gains from international cooperation through capacity-building to provide support for this activity.

Similar arguments apply to policy review and evaluation. And it is important at

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this second stage to link the policy reviews to the goals of a country's development strategy.

While WTO members can contribute to capacity-building for policy transparency and policy review, the WTO through the structure of the GATS provides valuable guidance on the information that should be collected and reported in these stages. The relevant policy information is not simply the treatment of foreigners, but the policy applied to all potential entrants into a market. The references in the GATS to market access, national treatment and domestic regulation issues provide a structure for this information.

The same arguments apply yet again to reform. The main gains are from commitments on market access and domestic regulation; the main risks are from a focus on national treatment, which typically happens in both regional and multilateral trade negotiations. The GATS provides guidance on the distinction between market access, national treatment and domestic regulation, admittedly with some uncertainties in definitions that could be clarified (Adlung 2006).

Having decided on the priorities for reform, countries can commit to those changes in the WTO. This contribution is more valuable than negotiations with foreigners on the terms of their particular entry into markets. While additional pressure from abroad can help countries to overcome the domestic political constraints to reform, there is the risk that in the services area, other countries may make demands that are not in the reforming country's best interests. That evaluation is best done domestically, away from a negotiating arena.

Given the relatively high resource cost of making and implementing good policy, it is unlikely that all countries can or should move immediately to 'world's best practice' in all regulatory areas. The scope to make the transition to that practice is important. The WTO through the GATS provides options for scheduling policy changes, and thereby creating expectations about the direction of policy reform. But the challenge is to strengthen the scheduling process and avoid the lack of clarity that is a feature of current commitments (Adlung 2006).

Finally, in some cases, policy choices in one country spill over to welfare effects in another. For example, the application of systems of safety standards or testing procedures by one group of countries could affect demand for the exports of other countries. Competition policy choices such as merger approvals in one country can affect markets in other countries where merging firms compete.

These spillovers are best resolved through a commitment to openness in the application of solutions. For example, countries adopting systems of mutual recognition with respect to standards or testing could usefully agree to take in new members on the same terms as they themselves joined the arrangement.

Similarly, it is important in competition policy to consider the welfare of all affected consumers where mergers have cross-country effects. The WTO provides a forum for the design of arrangements in which non-founding members can have a say about the rules adopted and about the terms on which they may later participate.

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4 Conclusion

So, to summarise, what should happen with services? Among the items that should be on the agenda are:

- Cooperation on transparency and review.
- Efforts to bind current policy.
- A focus on market access and domestic regulation in further liberalisation.
- Clarity on scheduling.
- Specification of paths of evolution of regulatory reform.
- Capturing the spillovers in that work.

These are primarily matters of the design of domestic reform, not international negotiation on the exchange of commitments to provide foreigners with options for market entry. The WTO's contribution is through its principles not necessarily its traditional processes, and in that sense, services cannot be a deal-maker in the Doha Round of trade negotiations.

The question, in other words, is not what services can do for the WTO and its negotiations, but what the WTO and its principles can do for services reform.

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