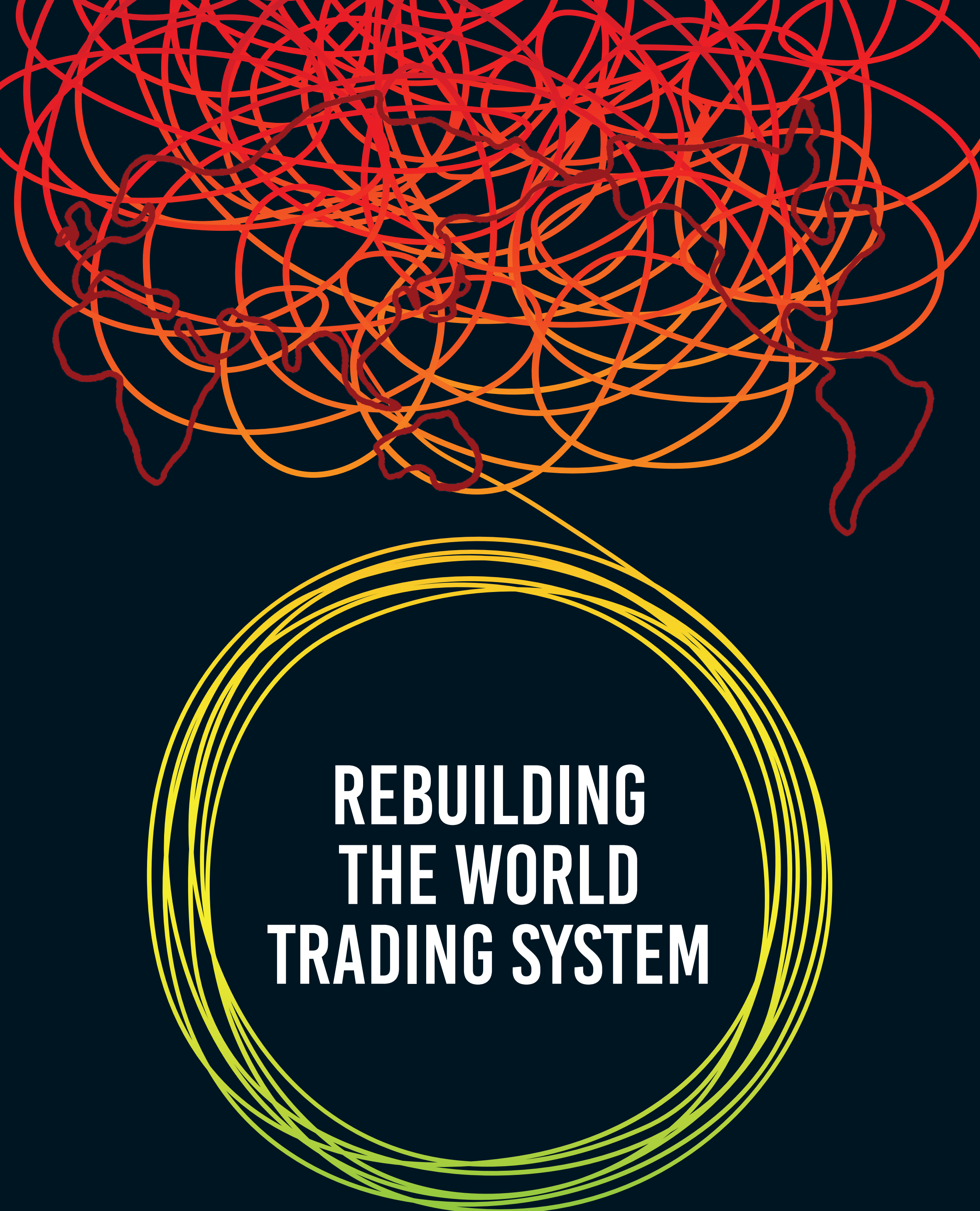

REBUILDING THE WORLD TRADING SYSTEM

ANDREW STOECKEL

Rebuilding the World Trading System

Andrew Stoeckel

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FOREWORD

Calls for root-and-branch reform of the world trading system are common for good reason. The main functions of the World Trade Organization system are failing or stalled, protectionism has risen, and trade policy has been weaponised by the majors.

Trade is the commercial exchange of goods and services across borders. It is driven by businesses who do the buying and selling. Small and medium business enterprises (SMEs) are the engine rooms of economies. For some, they account for the vast bulk of economic activity. Yet SMEs are rarely consulted on their views about trade and what rules would help facilitate commerce. Partly this lack of consultation is because there are so many SMEs – millions, in fact. Partly it is because individual SMEs do not have the resources to analyse problems and suggest remedies. Hence the responsibility of peak bodies representing SMEs to inject their views.

The Confederation of Asia-Pacific Chambers of Commerce and Industry (CACCI) represents over 150 million businesses across 22 member nations that employ perhaps a billion people. CACCI last injected their views on global trade policy during the Uruguay Round of negotiations that proved successful. The approach then was to commission an independent study that members could react to and distil their recommendations. That study was titled *Western Trade Blocs: Game, Set or Match for Asia-pacific and the World Economy?* by the Canberra-based Centre for International Economics.

The previous success has led CACCI to commission this independent study to explain to members what is behind today's trade policy problems and where the solutions might lie. This study has been an eye-opener for our members. It helps explain why some steps that stand to improve the trade system have yet to be made by various groups working on the issue such as the G7 and G20.

Based on this independent study, our understanding of the root causes of the problem has led CACCI to adopt its own set of recommendations on ways to improve the world's trading system. These have been published as *Achieving a Successful World Trading System*, a companion booklet that is available electronically at www.cacci.biz.

CACCI believes these actions will make a material difference to the World Trade Organization system and improve living standards.

Samir Modi
President
Confederation of Asia-Pacific Chambers of Commerce and Industry

CONTENTS

ACKNOWLEDGEMENTS

With the usual caveat on remaining errors and omissions, I would like to thank many people who have helped formulate this study and suggest improvements.

Credit for conceiving the study goes to Ken Court, a former Australian CACCI President and currently Chairman of the CACCI Advisory Board. Ken recognised the seriousness of the demise of the World Trade Organization system and the need to prosecute the idea that, once again, small and medium-sized businesses around the Asia-Pacific needed to put concrete proposals forward on how to improve the world trading system. Bryan Clark, Director of the International Chamber of Commerce Australia, gave leadership to the project as well as many ideas and constructive comments.

Thanks also go to the Steering Committee formed to provide valuable comments and inputs on the substance and coverage of the study under the chairmanship of current CACCI President, Samir Modi (India). Beside Ken and Bryan, other members of the committee were Benedicto Yujuico (the Philippines), Jemal Inaishvili (Georgia), Peter McMullin (Australia), Sheikh Fazle Fahim (Bangladesh), Pedram Soltani (Iran), Kazuo Nishitani representing Teruo Asada (Japan), Mustafa Bayburtlu representing Rifat Hisarciklioglu (Turkey) and Ernest Lin representing the CACCI Secretariat.

Interacting with the committee members helped hone the arguments and hopefully present them to a wide audience. Many of these members sought and received helpful input from trade experts within their own countries. Two people whose comments were helpful were Professor Syed Ferhat Anwar, Institute of Business Administration, University of Dhaka, and Dr Sait Akman, Director, G20 Studies Centre, TEPAV, Turkey.

Ross Lambie and former colleague George Reeves kindly helped clarify the economic arguments. Editorial input was provided by Lorna Hendry, working under tight deadlines. Their input is gratefully acknowledged.

This book builds on previous studies on trade conducted over thirty years while I was at the Centre for International Economics. It repeats and reworks material from two studies in particular: *Termites in the Basement* and *Policy Transparency* – the latter being co-authored by my former colleague Harden Fisher. All of this work has benefited from lively debate with former colleagues and much of it supported by the Rural Industries Research and Development Corporation, for which I am most grateful.

Finally, I would like to thank CACCI for their financial support that allowed this worthwhile project to go ahead. Full membership of CACCI and sponsors are detailed in the companion Policy Statement by CACCI titled *Achieving a Successful World Trading System* available at www.cacci.biz. It would be most gratifying to see these ideas adopted by policymakers as the potentially enormous prize.

CHAPTER 1

Introduction

'If economists ruled the world, there would be no need for a World Trade Organization,' wrote Nobel laureate Paul Krugman[1] in 1997. He went on to explain, 'The economist's case for free trade is essentially a unilateral case: a country serves its own interests by pursuing free trade regardless of what other countries may do.'

Yet we do have a World Trade Organization (WTO) and it has been judged to be important in creating a multilateral system of international trade in goods and services of great benefit to the world. Indeed, Martin Wolf, Chief Economic Commentator of the *Financial Times*, has argued that the WTO is an effective system of international economic law and 'it is the greatest achievement in institutionalized global cooperation, *tout court*'.[2]

So why do we have a WTO? Is it still fit for purpose? More relevant, why is the international trading system described as being in 'crisis' by the European Union, with calls from the United States for a 'reset' that 'piecemeal reforms' will not fix.[3] The G7 have called for 'root-and-branch' reform.[4] What has gone wrong that the G20

1 P Krugman, 'What should trade negotiators negotiate about?', *Journal of Economic Literature*, vol. XXXV, 1997, pp 113–20.

2 M Wolf, 'What the world needs from the multilateral trading system', in GP Sampson (ed), *The role of the World Trade Organization in global governance*, United Nations University Press, Hong Kong, p 186.

3 R Lighthizer, 'How to set world trade straight', *Wall Street Journal*, 20 August 2020. https://www.wsj.com/articles/how-to-set-world-trade-straight-11597966341

4 G7 Panel on Economic Resilience, *Key policy recommendations* [PDF]. https://www.g7uk.org/wp-content/uploads/2021/06/G7-Economic-Resilience-Panel-Key-Policy-Recommendations.pdf

had to advance the Riyadh Initiative on the future of the WTO?[5]

It is tempting to blame President Trump's administration for the current failings of the multilateral trading system. Certainly, Trump accelerated its demise, rejecting multilateralism and triggering a trade war with China in particular. But the Doha Round of trade talks failed long before he assumed office or even began his campaign for the presidency. In 2004, the WTO Ministerial Conference in Cancun collapsed in dismal failure when there was no agreement on a host of issues, including decision-making in the organisation itself.[6]

Before Cancun, there was the failure to launch a new round of multilateral trade talks at the 1999 WTO Ministerial Conference in Seattle, where protesters disrupted the meeting and damaged parts of the city in what became known as the 'Battle of Seattle'. President Clinton was in charge then. Clearly, the rot in the WTO system began long ago. This rot has been compounded by new developments in a fast-changing global macro-environment of hyper-globalisation and digital economy explosion.

... the rot in the WTO system began long ago

It is widely acknowledged there is an enormous problem with the world trading system. Alongside the G20, the Director-General of the WTO and many others agree that the WTO should be reformed. Their suggested remedies, while helpful, do not prioritise or explain what is most important and why. Worse, they do not mention several reforms that would help to secure an open, rules-based trading system.

One important reform is notably absent from the calls for a reset. This one change, while seeming radical, is not new or unrealistic. It was recommended by an expert group[7] set up by Arthur Dunkel, the Director-General of the General Agreement on Tariffs and Trade (GATT), the precursor of the WTO, prior to the Uruguay Round that started in 1986. It was also suggested four years later by a working group

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5 G20 Information Centre, *G20 Trade and Investment Ministerial Meeting: Communiqué, Annex I: Riyadh Initiative on the future of the WTO,* 22 September 2020. http://www.g20.utoronto.ca/2020/2020-g20-trade-0922.html#a1

6 Besides the inability to agree on whether to start negotiating new WTO agreements on the 'Singapore issues' (investment, competition, procurement and trade facilitation, so-called after their introduction at the WTO Ministerial meeting in Singapore in 1996,) there were fundamental disagreements on agriculture and decision-making and input by developing countries.

7 F Leutwiler and B Bradley, *Trade policies for a better future*, GATT Secretariat, Geneva, 1985.

chaired by Olivier Long, a former Director-General of the GATT.[8] But the change that was made was only partly implemented and it contained a fundamental flaw that made it ineffective.

A misunderstanding about why this potentially powerful remedy to bad trade policy works led to its partial adoption in the Uruguay Round. This compromise ended up being ineffective. Moreover, the mechanism the supposed remedy spurned is beyond repair.[9] It was a good idea that required multiple elements to be fully effective – like cogs on a wheel – and a seemingly sensible compromise led to its failure. This one idea has been shown to work effectively,[10] but unfortunately it has only been adopted in a couple of countries, although a few more have flirted with the idea.

At this point, it will be very tempting to skip to the end of this report to see what the proposed solutions are, what is missing from current recommendations and what this single most important reform might be. But unless there is an understanding of why these changes help fix the problem, the motivation to adopt them will not be there. They will be seen as unrealistic and rejected out of hand. However, an appreciation of the basics of the world today, how the economic system functions and where logic leads us will show that these steps are the right ones. They are the minimum for a well-functioning system of international trade. Also, we have already seen what happens when there is compromise without an understanding of the economics of trade policy.

Not all the answers are clear. There are three areas – the digital economy, intellectual property, and special and differential treatment for developing countries – that need further solid analysis. It is necessary to go back to basics and answer these questions:

- Why do we need the WTO?
- What should the WTO system do and how?
- What has gone wrong with the WTO system?
- What steps are needed to fix the WTO system?

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8 O Long, et al., *Public scrutiny of protection: domestic policy transparency and trade liberalization*, Trade Policy Research Centre, London, 1989.

9 B Carmichael, *Trade policies at the cross-roads*, Asia Pacific Economic Papers, Australia–Japan Research Centre, ANU, Canberra, 2005.

10 G Banks and B Carmichael, 'Enhancing transparency in the multilateral trading system', paper presented to the Lowy Institute and Tasman Transparency Group Conference, 4 July 2007, Sydney.

There is a mountain of literature on trade policy by economists, most of it good, most supporting an open, rules-based, multilateral trading system. Having analysed trade policy myself over decades, including complex modelling and measurement, and analysis of the political economy of trade policy, it is disappointing that this work has failed to convince policymakers of a better set of arrangements to benefit the planet. Evidence-based policymaking seems to have gone out of the window.[11]

If the problems of the WTO system were simple, they would be fixed already.

If the problems of the WTO system were simple, they would be fixed already. It is important to appreciate the complexity of the problems. There are four main reasons for the demise of the WTO:

- an agenda that, through 'mission creep', is too big and inappropriate for the primary objective of an effective world trading system
- well-known problems that stem from a world of sovereign nation-states but not fixed by policymakers. These problems have slowly eroded the foundations of the WTO system
- a new context for trade in a fast-changing digital world
- the decline of both multilateralism and hegemony of the United States less willing to back the multilateral system.

To appreciate what has gone wrong and understand the solutions, this report will try something different. It starts with the economic principles and features of the world trading system that are under-appreciated. This explains why some essential solutions have, so far, not been advanced by those advocating reform. Again, to understand which reforms are essential, the reader is urged to read the full report and resist the temptation to skip ahead.

- Chapter 2 describes the basic building blocks of the world trading system that resonate with our intuition – the nature of markets and exchange of goods and services. It discusses how the world has changed since the 1944 Bretton Woods conference that was

11 Of course, the real measure of success of this vast literature is the counterfactual – what would things be like without it? Maybe far worse! And the worst pandemic-induced recession for a hundred years has, with a few notable exceptions, seen global supply chains and trade continue to function. But the point is still there: the problem remains with the need for reform. The literature has failed to prevent that.

the genesis of the GATT (later to become the WTO) as well as today's World Bank and the International Monetary Fund (IMF).

- Chapter 3 shows that a reformed WTO system can be beneficial, but that its focus should be different and that different, simplified rules are needed to improve outcomes.
- Chapter 4 describes the purpose of the WTO system and the principles it should apply to achieve its aim.
- Chapter 5 diagnoses the current problems in the WTO system and shows why change is needed.
- Chapter 6 outlines the solutions, which by this point of the report will be clear.

CHAPTER 2

What lies behind trade?

Trade is the commercial exchange of goods and services across borders. It is driven by market-oriented businesses, and some basic characteristics shape the right rules to facilitate that trade. The basic economic principles and features that shape the best design of the world trading system are outlined here.

Basic building blocks

1. The nation-state is the only game in town

The world is made up of a number of nation-states. The sovereignty of the nation-state is generally respected around the globe. Richard Haass, president of the Council on Foreign Relations, puts it eloquently:

> The bedrock of world order, since the Treaty of Westphalia that ended the Thirty Years' War in Europe in the mid-seventeenth century, has been respect for sovereignty and the idea that borders ought not to be changed forcibly. This has become the closest there is to a universal principle promoting order in the world. Only countries, sometimes referred to as states, nations, or nation-states, can claim sovereignty.[12]

There is no global government, nor is there likely to, so there is no global police force to enforce rules. Note that global *government* is different to global *governance* – the institutional arrangements put in place

12 R Haass, *The world: a brief introduction*, Penguin, New York, 2020.

by the world community to manage a global aspect such as trade. The WTO is just one example. The World Health Organization (WHO) is another.

Several things follow from this basic fact. It is behind the 'trilemma'– the impossibility of achieving hyper-globalisation, democracy and sovereignty – described by economists Dani Rodrik and Larry Summers.[13] At best, only two of those three can be achieved. The point to note is that sovereign governments set the rules governing economic activity inside their borders, and that sovereignty is mostly respected around the world.

2. Modern markets only exist with government rules

The exchange of goods and services has happened since the evolution of humanity. But modern markets with anonymous exchanges between buyers and sellers only exist with the underpinnings of government rules and standards.

These rules and standards cover property rights, the enforcement of contracts, setting and enforcing standards, regulations to address negative spillovers or 'externalities', secure payments settlement and more.

This edifice of rules and standards can be loosely called 'scaffolding'. Markets, in the modern sense, would not function without this scaffolding, and the scaffolding varies across markets and across countries. There is no one 'right' model and what works best depends on the interplay of rules and social norms. When they work well, markets efficiently deliver goods and services at least cost in the right amounts, right places and at the right time. This is all voluntary exchange that is mutually beneficial to the buyer and seller.

Sometimes markets don't work well. They are said to 'fail' – often due to spillovers, mostly from some underpriced resources such as 'clean water'. Sometimes one party to the exchange has better information about the good or service being exchanged. This is known as 'asymmetric

13 Dani Rodrik discusses the implications of the nation-state in his books (among others), *Straight talk on trade: ideas for a sane world economy*, Princeton University Press, New Jersey, 2018, and *The globalisation paradox: why global markets, states, and democracy can't coexist*, Oxford University Press, 2001; L Summers, *Reflections on managing global integration*, Annual Meeting of the Association of Government Economists, New York, 1999. https://www.treasury.gov/press-center/press-releases/Pages/rr2877.aspx

information', and it is important in the digital economy. Some spectacular failures, such as the 2008 global financial crisis (GFC), result from failed regulations. When this occurs, it is up to government to fix the regulations (provided the benefits exceed the costs) so that better outcomes result.

Sovereign governments can enforce the essential scaffolding that supports markets for efficient exchange *within* the nation-state. But what happens when someone wants to buy or sell from another country, where the scaffolding is different? Whose rules and standards should apply? How should differences be resolved? Wouldn't there be gains from having a set of rules for the exchange of goods and services across borders? Yes. What these gains are and how these rules should be set and enforced is what this report is about.

3. International law is different to domestic law

A frequently heard phrase is the importance of a 'rules-based international order', which covers many subjects, such as peace and security, nuclear disarmament, human rights, the environment, and navigation of the seas and airspace. In a trade context, this is the 'rules-based multilateral trading system'.

Rules can help create certainty, which encourages investment.[14] They are essential for modern markets to function, and can make markets across borders more efficient. But the domestic rules enforced within a nation-state that allow markets to flourish are different to those that work internationally. This difference in enforcement has a major bearing on the most important recommendation of this report. It also explains why the dispute settlement system of the WTO is not working. So what is international law and how does it work?

International law is simply the set of rules that countries follow in dealing with each other[15] Just because there is no global authority to enforce compliance with the international rules, as happens with domestic

14 In passing, the gain from reducing uncertainty in international trade from more predictable rules is rarely measured. Two exceptions are K Handley and N Limao, 'Policy uncertainty, trade, and welfare: theory and evidence for China and the United States,' *American Economic Review*, 107(9), 2017; and A Stoeckel, WJ McKibbin and KK Tan, *Productivity, risk and the gains from trade liberalisation*, Pelham Papers, no. 9, Melbourne Business School, Melbourne, 2000.

15 Globalisation 101, *International law and organizations* [PDF], accessed 18 August 2021. https://www.globalization101.org/uploads/File/Inter/interall.pdf

law in a nation-state, does not mean it is not 'law'. But international rules have different characteristics and compliance incentives to domestic laws.

Compliance with international rules boils down to nation-states following the rules they have agreed to because it is in their own self-interest to do so. The operative words are 'agreement' and 'self-interest'. For a rules-based trading system to work efficiently, rules must be agreed to and countries must be able to assess what is in their self-interest. Note that, because the nature of trade is win–win, retaliation to enforce compliance with trade rules can never be effective.

4. Outcomes are the result of behaviour in response to incentives

People like to become better off. 'Better off' can encompass many things: cleaner water or air; safe, secure surroundings; more income; and many more. One list of important human aspirations is the 17 Sustainable Development Goals in the Agenda 2030 adopted by all United Nations (UN) member states in 2015. These goals cover health, education, gender, inequality, jobs and more, but they all have one thing in common: they are outcomes.

These outcomes are the result of human behaviour. In turn, human behaviour stems from incentives. Incentives come from both formal and informal rules in society, which Nobel laureate Douglass North called the 'rules of the game'. [16]

To change outcomes, incentives have to change, and that comes from changing the formal rules, the informal ones or both. The formal rules come from the laws of the land and the informal ones from social norms and codes of conduct. These norms stem from social belief systems, history and culture, which are hard to change. They evolve slowly. But these norms are important. That is why businesses devote so much effort to establishing and protecting the reputation behind their 'brand'.

The interplay of formal and informal rules differ across countries. This is the critical reason that there is no one 'right' model for market scaffolding or 'right' trade' policies to pursue.

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16 D North, *1990 Institutions, institutional change and economic performance,* Cambridge University Press, 1990.

The WTO does not set or enforce rules; its members do.

To use North's description, organisations administer the institutional arrangements – the 'rules of the game'. The WTO manages and facilitates the international rules of the game covering trade that have been agreed to by its members. The WTO does not set or enforce rules; its members do.

5. Self-interest is the strongest of motivators

Adam Smith said it all more than two centuries ago: 'It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest.'[17] Altruism and philanthropy exist, but the strongest motivator of behaviour is self-interest. It is the main driver behind the exchange of goods and services between buyers and sellers.

In this context, self-interest is business profits, but there is no inconsistency in achieving any other environmental or social goal, provided any spillovers from business activity are appropriately addressed. When they are (for example, through taxes or regulation), sustainable development goals are incorporated into the incentives businesses face, so the right social outcome is achieved in their pursuit of self-interest.

Self-interest can be harnessed to achieve anything that people believe will make them better off, such as health and education. There is a high correlation between income and better health, education and other sustainable development goals. Higher income does two things. It creates increased demand for non-market outcomes, like clean air, and it creates the resources to pay for these other goals. Pursuing higher income becomes a good proxy for the pursuit of many other sustainable development goals.

6. Competition is the discipline over the incentive to monopolise markets

If self-interest is a strong motivator, is it not also true that producers have an incentive to manipulate markets and lift prices and profits for themselves at the expense of the consumer? Yes. Adam Smith also recognised this. He wrote, 'People of the same trade seldom meet together, even

17 A Smith, *An inquiry into the nature and causes of the wealth of nations, vol. 1*, 1776.

for merriment and diversion but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.'[18] This leads to the important notion of competition and the fallacy of composition.

7. Fallacy of composition is common in trade policy arguments

A common misunderstanding is the supposition that what is good for the individual must also be good for the whole group. One person in a crowd watching a parade can see better by standing on a box, but if everyone stood on a box the outcome would be totally different.[19] This is a fallacy of composition: the inference that something is true of the whole from the fact that it is true of some part of the whole.

It is tempting to think that self-interest will lead to bad outcomes. But when there is also open competition, everybody acting in their own self-interest actually delivers a totally different result. The self-interest of competitors acts as a discipline on markets, and the common good is served.

It is even better than that. The baker's competitor down the road has an incentive to innovate. They may add exotic grains to make a better loaf of bread and win a bigger market share, out of their own self-interest. Other bakers follow suit, to avoid losing market share. When everyone does this, it results in more innovation and products that offer better value for money. The outcome is more prosperity. Self-interest is the motivation and competition is the discipline. Overall, everyone is better off.

It is the partnership between of self-interest and competition that creates the 'invisible hand' that guides the economy to produce the right amount of goods and services in the right places at the right time, and that makes people vastly better off. It sounds magical, and it is, especially when you consider that no-one is in charge. What could go wrong?

8. Resort to protection is a common source of failure

Plenty can go wrong with markets. The problems are clear: financial crisis, environmental degradation, rising inequality. Sometimes the

18 Smith, *Wealth of nations.*

19 LB Yeager and DG Tuerck, *Foreign trade and US policy: the case for free international trade*, Praeger Publishers, New York, 1976.

scaffolding surrounding the market is not well designed in the first place. Sometimes technology, culture or preferences change, rendering parts of the scaffolding outdated. Sometimes the economies of scale are so great that one or two companies can dominate a market at the expense of the consumer. This is being played out now in the digital world, which has just a few dominant companies. Sometimes governments are captured by vested interests, and they offer favours to a privileged few.

Mostly, when things go wrong it is due to a lack of genuine competition, inappropriate or insufficient regulation dealing with spillovers, or a lack of transparent information about the incentives of different players in the market. Sometimes the lack of competition is due to the nature of the product and economies of scale. But, sadly, too often the cause is capture of government by groups who receive favours through policy or payments. All too often this special favour is 'sold' to an uninformed public through a misguided, inefficient response to a spillover (which may be of genuine concern).

Problems in trade policy occur when governments give a company or industry a box to stand on to make them better off. Too often, this arises from concern about a competitive import from a foreign supplier and the potential loss of domestic jobs. Superficially, imposing a barrier on trade makes it look as if the foreigner is bearing the burden of an import barrier – hence its appeal to government. The foreign supplier does lose part of their market, which causes them to make loud complaints, fuelling the incorrect perception that it is the foreigner who bear the biggest burden.

The cruel irony of imposing an import barrier is that the bulk of burden is borne by one's fellow citizens. Someone local is always worse off, usually an exporter. The only purpose of an export is to earn the foreign exchange to pay for a valuable import. Stopping imports ends up stopping exports.

To export and earn foreign exchange, but not import goods or services, would be like being marooned on a desert island with a bucket of gold! An import barrier (in effect, an import tax) is simply a tax on exports. Why would you do that?[20]

To compound matters, often the local producers who are bearing the burden of import barriers cry for help and also demand a box to

20 That an import tax is an export tax is well known to economists, but the wider public do not appreciate this point. See A Stoeckel, 'Removing the hidden taxes on exports', in A Stoeckel and H Corbet (eds), *Reason versus emotion: requirements for a successful WTO round*, RIRDC, publication no. 99/167, Canberra, 1999, p 82.

stand on. Soon no-one is better off, except, of course, the 'box-making' industry' – lobbyists, rent-seekers and policy designers. The result is a plethora of regulations and interventions that leave everyone worse off. This is why protection for everyone is in effect no protection at all. It really is a case of 'everyone standing on a box to watch a parade'. No-one is better off.

... protection for everyone is in effect no protection at all

9. The case for free trade is a unilateral one

The previous point warrants more discussion. It goes to the heart of the trade problem and why the best remedy is not even on the agenda. The bitter experiences of the collapse of world trade in the 1930s made a major impact on the framers of the multilateral trading system. The *raison d'etre* of the system was to prevent future trade wars and foster peace.

The beggar-thy-neighbour policies (which seek benefits for one country at the expense of others) and competitive devaluations of the 1930s were partly a result of the mistaken belief in mercantilism at a political level. That belief was that exports were good, but imports were to be minimised to accumulate as many foreign reserves – mainly gold and silver – as possible. The more foreign reserves a country accumulated, the wealthier and more powerful it was. Although great economists such as Adam Smith and David Ricardo had shown mercantilism to be economically wrong, this kind of thinking crept into the framework for conducting multilateral trade negotiations under the GATT.

Mercantilist thinking prevails in nearly all ministries of trade around the world today. These ministries promote exports, but never promote imports; in fact, most work to prevent imports if they can. This undercurrent of mercantilist thinking is now a major obstacle to trade policy reform.

'But surely imports cost jobs?' you might ask. Not overall. Extra imports need extra exports, and exports are more efficient users of resources, generating jobs. The result is in an overall improvement of welfare from specialisation and trade. In 1990, a large study by the World Bank established the point that, overall, imports do not cost jobs. [21]

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21 D Papageorgiou, AM Choksi and M Michaely, *Liberalising foreign trade in developing countries*, World Bank, Washington DC, 1990.

Economists have demonstrated at length the fallacy behind mercantilism and the 'exports are good, imports are bad' message. Arithmetic alone should be enough to demonstrate this: someone's exports must be someone else's imports. If everyone adopted the 'imports bad' message, there could be no exports! Perhaps more compelling is the analogy used by Paul Krugman[22] and Jagdish Bhagwati[23], among others, that just because someone else throws rocks in their harbours does not mean you throw rocks in your own.

Regardless of what others do, you are better off reducing your own barriers to trade. The purpose of an economy is to consume. There is no point in producing something if it is not going to be consumed, and if it can come from overseas on better terms, so much the better. Unfortunately, you have to pay for imports with foreign exchange. That is the value of exports – it allows you to earn the foreign exchange, giving you more access to imports, lifting consumer welfare. The most successful exporters of the world have been the successful importers!

Many countries have successfully liberalised trade unilaterally. Bhagwati notes:

> The empirical reality shows extensive resort to unilateral trade liberalization in the last two decades in Eastern Europe, in Latin America (especially Chile), in Asia (especially in Australia, New Zealand, and Indonesia, and since 1991 in India as well), and yet earlier in Singapore and Hong Kong.[24]

10. International trade is highly beneficial

There have been plenty of studies measuring the gains from international trade.[25] Globalisation has lifted over one billion people out of poverty

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22 Krugman, 'What should trade negotiators negotiate about?', *Journal of Economic Literature*.

23 J Bhagwati, *Free trade today*, Princeton University Press, New Jersey, 2002.

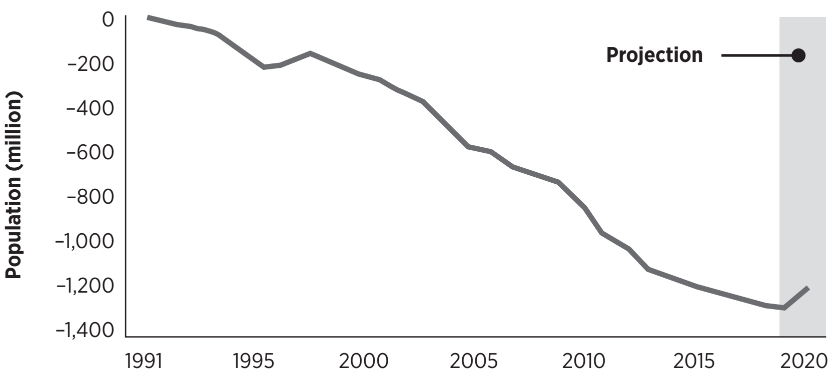
24 Bhagwati, *Free trade today*, p 105.

25 The OECD and World Bank have done many studies, for example, see OECD, *The impact of trade liberalisation on jobs and growth: technical note*, OECD Trade Policy Papers, No. 107, OECD Publishing, Paris, 2011. http://dx.doi.org/10.1787/5kgj4jfj1nq2-en. Interestingly, CACCI commissioned an independent study during the Uruguay Round and it showed global gains of an increase in world incomes of over 5 per cent from a halving of tariff and non-tariff barriers. See A Stoeckel, D Pearce and G Banks, *Western trade blocs: game, set or match for Asia-Pacific and the world economy?*, Centre for International Economic, Canberra, 1990. Incorporating dynamic effects (see Box 1) can give larger effects.

over the last few decades (Figure 1) and raised life expectancy by over 10 years (Figure 2).

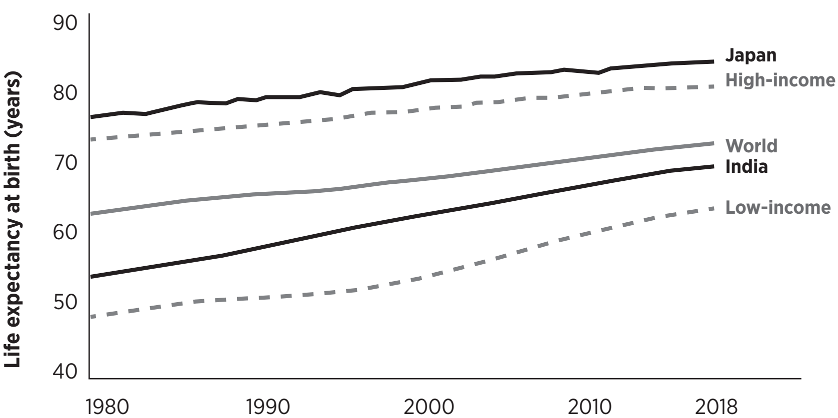
You don't need economic models or numbers to see the benefit from trade – it is right before your eyes. In March 2021, the image of a giant container ship stuck in the Suez Canal featured on the news bulletins across the world. The ship was jammed in the canal with containers stacked high on its deck, blocking hundreds of other ships that were waiting to use the waterway. That was just one of the 5,000 or more container vessels that ply the world's oceans, and the Suez Canal is just

Figure 1: Cumulative change in global population in extreme poverty, 1991–2020



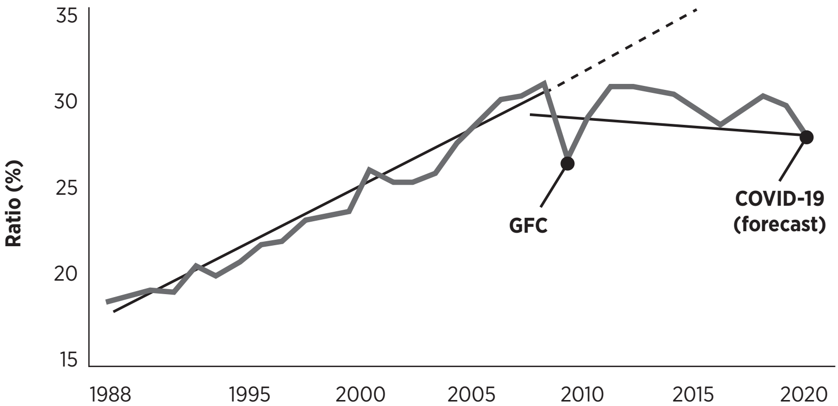
Note: 'Extreme poverty' means below US$1.90 per day at 2001 purchasing power parity
Source: World Bank and UN Population project.

Figure 2: Life expectancy at birth, 1980–2018



Source: World Bank

Figure 3: Ratio of world exports to gross domestic product, 1988–2020



Source: World Bank database; author's forecast 2020.

one of the shipping routes between ports, accounting for only about one-tenth of world shipping. On top of that is all the land-based road and rail freight that crosses borders. Add to that the cross-border trade that you can't see – services and financial trades, as well as data flows – and you begin to comprehend the massive exchange of goods, services and capital across borders.

Virtually all this trade is voluntary commercial exchange between private firms and/or individuals. Trade on this scale would not happen unless it was of immense value. It has grown as a share of world production (Figure 3). The concern now is that since the 2008 GFC, the growth of world trade as a share of world production has stalled.

11. Gains from trade come from relative differences

Fundamental to the pattern and direction of trade is the concept of comparative advantage. Absolute advantage is easy to see in trade – for example, if the climate for banana production is better in Africa than in England, England will buy bananas from Africa. Comparative advantage is more subtle and powerful. Gains from trade come from relative differences in costs within a country, not cost differences between countries. A country will export the things it has a comparative advantage in and import the things it has a comparative disadvantage in. Because there are always relative differences (which can change over time), it always pays to specialise and trade.

The specialisation that drives commercial exchange within a country is the same driver as for commercial exchange across borders, but with two differences. First, selling or buying from another market across a border means accepting someone else's standards and rules. Second, citizens generally care less about the welfare of foreigners than they do about their fellow citizen, which is why the world has gravitated around a series of sovereign nation-states.

12. Barriers to trade are costly

If trade is highly beneficial, it must follow that barriers to the exchange of goods and services are costly. Of course, there are instances where the private benefit from commercial exchange does not include spillovers or external effects, such as national defence and security. In such cases, barriers might be warranted in the national interest. However, there are alternatives, such as stockpiles of inventories to guard against disruptions to trade, which gives rise to questions about how genuine the national security argument is.

13. 'Cost' is the lost income from the misuse of resources

There is a common misconception about what the 'cost' of a trade barrier is. If a $10/tonne tariff is imposed on 50 million tonnes of steel imports to protect a local industry, to some, the cost of the tariff is $500 million but that is not the real economic cost to the nation. The $500 million is the tariff revenue, and that money can be used for other things, such as building roads, that benefit the economy.

The real economic cost comes from the flow-on ripple effects that distort the pattern of resource use in the economy. Because of the tariff, domestic steel producers will be able to charge $10 more for every tonne of steel. They pass this onto customers, such as builders, who pass it on to their customers, and so on. Some of these customers will be exporters. Everyone tries to pass the costs on. Most do, except the exporters, who are least able to do so. They face intense competition on the world market and stand to lose market share. (Remember: an import tax works as a export tax!) In this example, more resources will be diverted to domestic steelmaking, but these resources have to come from somewhere else. Other industries will be forced to contract, shedding workers. Too often the shedding of workers is from export industries, which are the efficient users of resources in an economy.

The 'cost' of the $10/tonne import tariff is the lost opportunity for the nation to be better off. This is called the 'opportunity cost'. Opportunity cost is not something that can be looked up in the national statistics or in a government's budget. Opportunity cost is what you give up to pursue something you want. It must be calculated.

Opportunity cost is what you give up to pursue something you want.

Because of the flow-on or ripple effects from an import barrier, the assessment of opportunity cost must be economy-wide and address the question, 'Where else could resources be used?'[26]

As well as gains from better use of resources, there are additional macroeconomic gains of a dynamic nature. These are the gains from faster capital accumulation and growth over time (Box 1). Using resources where they are more productive lifts the return on capital, promoting investment and capital accumulation. Opening to trade increases competition, promoting productivity. Finally, better open policies can lower risk, again promoting investment and growth.

To do this estimation, we need models and calculations that require expertise. This may sound like basic economics, but it has powerful implications for solving the problem with the WTO system. To make an informed decision about what is in the nation's interests, the national interest has to be measured and it has to be economy-wide. It has to look at all impacts, both private and social, on all groups. This has to be done in a way that is credible and believable. This is a fundamental point that will be discussed in the plan for action in Chapter 6.

26 Henry Hazlitt's 1946 book, *Economics in one lesson,* is the classic text here. For an updated version of the principle of opportunity cost to reflect that market prices do not always reflect social costs, and why we should be concerned about social opportunity cast, see J Quiggin, *Economics in two lessons,* Princeton University Press, 2019.

Box 1: Measuring the macroeconomic gains from trade liberalisation: big gains for Indonesia, Malaysia, Philippines and Thailand

A big part of the cost of trade barriers is the distortion they create in how a nation's scarce resources are used. Some industries are favoured at the expense of others, so there is an opportunity cost from not using resources in the most productive way. Many economic models capture this effect.

But there is more. There are additional gains that are not usually measured because the models required to capture these effects are more sophisticated. For large economies, a trade barrier can change the terms of trade, which affects welfare. A multicountry global trade model is needed to capture this effect.

Next, we must recognise that using resources in a better way lifts the return on capital, encourages investment and encourages capital accumulation. Growth is higher. A dynamic model with an integrated financial sector is needed to capture this effect.

A third source of gain is the potential of increased competition from more open trade to boost productivity. The size of this effect may be controversial, but is nevertheless real. This was a large component in the calculations of the impact of Brexit by the UK government. More productivity also encourages capital accumulation.

A fourth effect is that being more open to the world economy lowers country risk, again encouraging investment and capital accumulation. There is a discipline on policymakers in more open economies whereby 'silly' policies show up quickly in exchange rates, inflation, exports haemorrhaging or some other imbalance. Financial markets know this.

There are also costs from trade liberalisation often not captured in trade studies. Resources, in particular labour, do not move without some adjustment costs. And changing incentives to invest changes capital flow s which have exchange rate effects directly impacting exports and imports. All benefits and costs should be considered.

Measuring these effects requires a dynamic intertemporal general equilibrium model. One example is the G-Cubed model, (a recent description of features is in McKibbin and Stoeckel, 2018). Early work with this model by Stoeckel, McKibbin and Tang gave the following gains (net of adjustment costs and macroeconomic effects)) from full trade liberalisation of world trade phased in from 2000 to 2010 for several Asian economies.

Change in real consumption from baseline as a percentage of GDP in 2010

Malaysia	20.9	Thailand	19.1
Indonesia	14.3	Philippines	10.8

That analysis is somewhat dated, but that is the point: there are not many studies of all the benefits and costs of multilateral trade liberalisation. Studies for sectors like agriculture exist as do studies of bilateral trade agreements. But these do not capture all macroeconomic benefits and costs. The results above are illustrative of the potential gains in welfare that are possible from a more open, predictable world trading system.

Source: W McKibbin and A Stoeckel, 'Modelling a complex world: improving macro-models', *Oxford Review of Economic Policy*, 34(1–2), 2018, pp 329–347; A Stoeckel, WJ McKibbin and KK Tan, *Productivity, risk and the gains from trade liberalisation*, Pelham Papers, no. 9, Melbourne Business School, Melbourne, 2000.

14. Resources are limited, so choices have to be made

Building on the idea of opportunity cost, societies have to make choices about how best to use their resources based on what is important to them. All resources are scarce and can be used in alternative ways. Trade-offs have to be made. One nation-state may place education as the top priority, another may prioritise public health. The relative importance of the UN's Sustainable Development Goals will differ across nations, and it is up to each sovereign nation-state to make that choice.

One example of the different choices that can be made is the Copenhagen Consensus 2012 project, which looked at how best to spend $75 billion to save the world.[27] The most worthy investments were diverse: reducing malnutrition, stepping up immunisation, a variety of human health improvements and even borehole and public hand pump intervention. The most important was found to be to step up the fight against malnutrition. They demonstrate the choices societies face and how different societies will choose differently. These differences become reflected in spending patterns and market interventions that can affect the pattern of trade and the policies adopted.

27 B Lomborg, *How to spend $75 billion to make the world a better place*, Copenhagen Consensus Centre, 2014.

Our changing world

As the world changes, the rules need to change. Three large global trends over the last two decades affecting trade are the rise (and stall) of hyper-globalisation, the large demographic shift in China and the explosion of the digital economy.

Hyper-globalisation

Trade has exploded as a share of world GDP over the last three decades. From under 20 per cent of GDP in 1998, exports rose to over 30 per cent prior to 2008. Since then, globalisation of goods and services trade has stalled – partly because of two major recessions, one from the GFC in 2008, one from the current COVID-19 pandemic. The most recent recession has called into question the over-reliance on global supply chains for critical parts. Greater resilience on behalf of business has meant on-shoring of production to offset increased perceived risk from reliance on offshore markets.

The hyper-globalisation period is often attributed to China's rise as a manufacturing powerhouse. Hyper-globalisation is also blamed for stagnant real wage growth in the United States.[28] But this period is likely to be a one-off, not to be repeated. For now, there is no point in deliberating whether and how much China's rise might have impacted real wages in the United States or elsewhere. This period is over.

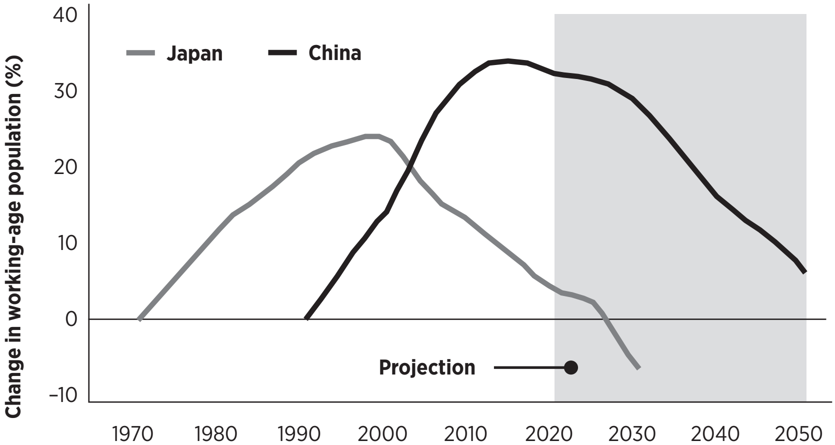
China's population demographics

A fundamental for economic growth is how many workers you have. Under China's market opening and economic reform, millions of workers, mostly from the countryside, found more productive work in factories across the nation. Combined with a rising working-age population (Figure 4), their economy boomed. But, under China's one-child policy, the working-age population has turned and with it, economic growth, although still high, will slow.[29] The pattern in China is similar to what happened in Japan two decades earlier. World trade will still grow along

28 For example, see DH Autor, D Dorn and GH Hanson, *The China shock: learning from labor market adjustment to large changes in trade*, National Bureau of Economic Research, Working Paper 21906, 2016. http://www.nber.org/papers/w21906

29 China has recognised this problem and has now announced a three-child policy.

Figure 4: Change in working-age population, China and Japan, 1970–2050



Source: UN Population Project

with rising economic activity, but growth as a share of world GDP is not likely.

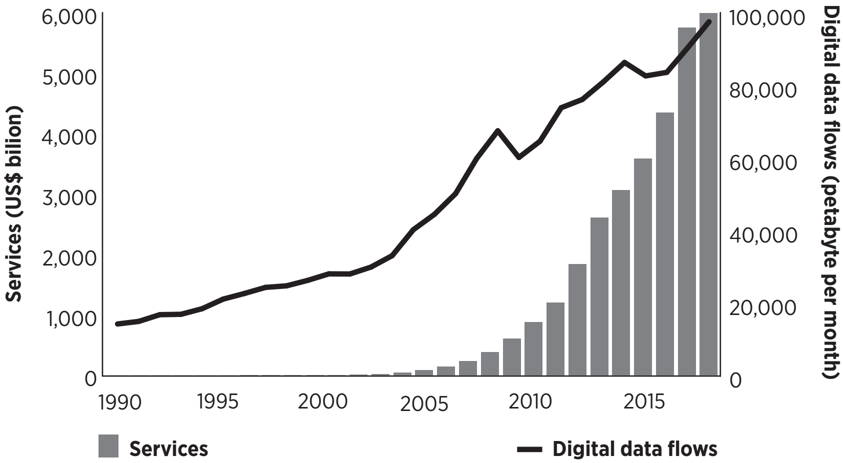
It is this large shift in demographics tied to economic development that lies behind the widespread concern mentioned above that the rise of China's exports has depressed real wage growth. But that trade shock is over and is unlikely to be repeated, as demographics are slow to turn around.

Digital explosion

While goods and services trade flows may have stalled as a share of GDP and capital flows fallen, digital flows have exploded (Figure 5). This digital explosion is evidence of renewed globalisation of a different type. In addition, the COVID-19 pandemic has accelerated digitisation by several years (Figure 6).

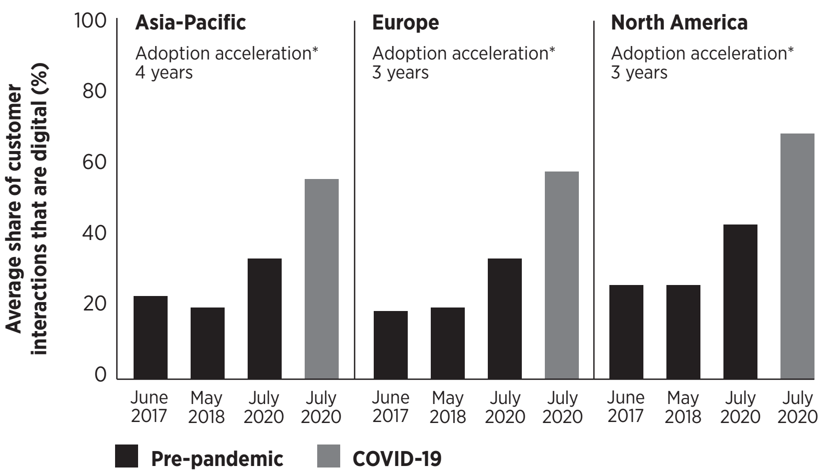
With increasing data flows comes an increase in concerns about privacy, cybersecurity and cyber-attacks on critical infrastructure, such as energy networks. Some of this activity is criminal in intent. Holding companies to ransom would be covered by ordinary criminal law. But if a computer system can be hacked, there is the possibility of malware being planted and other businesses being infected – an externality. The question is whether that warrants regulation, and how.

Figure 5: Global trade in data driven services has grown exponentially since 1990



Source: WDR team calculations, based on World Bank, WITS (World Integrated Trade Solution) database.

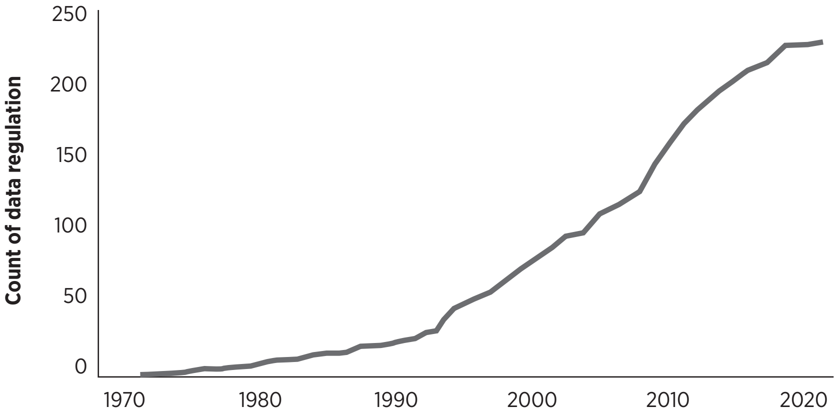
Figure 6: COVID-19 pandemic accelerates global digital uptake



* Note: Adoption measured by years ahead of the average rate of adoption from 2017 to 2019

Source: McKinsey & Company, 5 October 2020.

Figure 7: Cumulative number of data regulations, 1972–2019



Source: OECD Trade and Agriculture Directorate Trade Committee, *Trade and cross-border data flows* [PDF], OECD, 2018.

The Organisation for Economic Co-operation and Development (OECD) has estimated that the number of regulations covering digital cross-border are on the rise (Figure 7).[30] However, it is not clear what the effect might be. What are these regulations doing? Do we have the right regulations? One member of the steering committee for this project remarked, 'We have Business 4.0 but only Government 2.0.' Clearly there is a burning need to address the implications of the issues covering digital flows across borders.

'We have Business 4.0 but only Government 2.0.'

30 OECD Trade and Agriculture Directorate Trade Committee, *Trade and cross-border data flows* [PDF], OECD, 2018. https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=TAD/TC/WP(2018)19/FINAL&docLanguage=En

CHAPTER 3

Why do we need the WTO?

Putting together the blocks from Chapter 2 gives the following narrative. The market economy, encompassing domestic and international exchange, can generate enormous sustainable increases in prosperity and give people the resources to seek what they desire in life.[31] Those desires include sustainable development goals, such as health, education, clean water and air, security and so on. These are not goods that are purchased in a marketplace, but it still requires real resources for governments to deliver them. The market economy generates those resources. The combination of the motivation of self-interest and the discipline of competition in a market economy is required for the common good.

A market economy will not function without agreement on rules, and that agreement comes from cooperation within and between societies. Cooperation is needed to get effective competition. Think of an intense competition on a sporting field: the players have to agree on the rules.[32] Getting this mix of cooperation and competition right is a perpetual task! (Make a mental note of those three keywords: self-interest, competition and cooperation. They come up time and again.)

31 For an elucidation on why a market economy is the only arrangement to deliver what human beings want from life, see M Wolf, *Why globalisation works*, Yale University Press, 2004.

32 To continue the sporting analogy, commerce will refer to the cliche of 'a level playing field' to convey the concept of fair competition. Note too the informal rules or codes of conduct in a competition – rivals shake hands at the start, a player helps an injured rival, losers congratulate winners, and so on.

The fact that markets between buyers and sellers in a modern economy only work with government providing the 'rules of the game' – the scaffolding – has important implications for trade. This scaffolding differs across markets and countries. There is no one 'right' model, as the rules of the game depend as much on informal rules (such as honesty and trust) as they do on formal rules (the 'laws'). Informal rules depend on culture, which stems from history, customs, attitudes and beliefs that vary across nation-states.

In a world of nation-states, where sovereignty is respected, governments provide the scaffolding with enforcement within their borders so that efficient domestic exchange can occur. But what happens when buyers and sellers want to exchange across borders? Whose rules, standards and protocols should apply. How should differences be resolved? How should rules be enforced across borders?

In the absence of a global government, the solution is global governance – a fancy name for international cooperation. Global governance already occurs in a host of areas: navigation of the seas and airways, financial stability, world health, the environment, just to name a few. Arrangements to deal with climate change is one area being thrashed out now, with a meeting of the UN Conference of the Parties scheduled for November 2021 (COP26). For international trade, the agreement on rules for efficient markets to work across borders requires international cooperation and negotiation. All parties must have an incentive to comply with what is agreed – it must be in their own self-interest. Differences across nation-states have to be settled. In effect, taking advantage of the gains from globalisation requires some harmonisation: governments have to agree to some constraints on their sovereignty in exchange for other governments doing the same.

International law is only as good as voluntary compliance out of self-interest.

These rules take on the label of 'international law', but adherence to them is totally different to domestic law, where a legislature, judiciary, courts and police force exist. International law is only as good as voluntary compliance out of self-interest. Retaliation does not work, because trade is win–win. The gains are mostly unilateral, so you shoot yourself in the foot when you retaliate against another country's trade barriers.

The reliance on voluntary compliance with agreed trade rules is well understood by the WTO secretariate, yet many members cling to the notion that a dispute settlement system is essential. Alan Wolff, Deputy Director-General of the WTO, expressed it this way:

> The multilateral trading system depends almost entirely on Members voluntarily living up to their commitments. It is true that the structure of the WTO provides a remedy through dispute settlement, but international trade would largely cease if trade-restrictive measures that were inconsistent with the rules were as a regular matter put into place and only removed prospectively through lengthy litigation – after being ruled to be inconsistent by a dispute settlement panel, followed by an appellate finding, followed by adoption of the same by the WTO's dispute settlement body, followed by a ruling by a compliance panel, followed by threatened or actual retaliation.[33]

The bulk of trade occurs now under voluntary compliance. The incentive to comply with the rules can be strengthened by relying on the fact that it is in a country's own interests (mostly) to open its borders to trade. However, the realisation that this is the case is not always apparent, because the measurement of national interest is not made. In the absence of this measurement, narrow and vested interests distort the real picture so they can successfully win favours for themselves at someone else's expense.

One crucial role for the WTO is to provide a forum for negotiation among members to set rules and multilaterally open markets. This is not currently working well. For example, it has taken 20 years to negotiate the removal of fishing subsidies to stop depleting the world's fish stocks, and this negotiation is ongoing at the time of writing. But why do this negotiation multilaterally? Why not just let each pair of countries negotiate their own bilateral trade treaties? A series of bilateral agreements is not the same as a multilateral agreement, and it is important to understand why we need a multilateral system.

First, competition is vital for the discipline of self-interest and is a key driver of innovation and productivity. Competition is greatest when there are common rules across potential suppliers, so that consumers have the widest choice on the best terms. In other words, it is best when the same rules apply everywhere. This improves economic efficiency. The wider the scope of competing suppliers the better the outcome. In effect, creating open multilateral markets is one of the simplest and

33 A Wolff, *Openness, balance and trust are underlying values of the WTO*, WTO, 25 June 2020. https://www.wto.org/english/news_e/news20_e/ddgaw_25jun20_e.htm#fnt-6

most effective competition policies to implement. Bilateral trade agreements treat different trading partners differently and are discriminatory. They are the antithesis of open competition and create incentives to block multilateral trade openings.

Second, multilateralism is more efficient if there is one agreement across all parties. By comparison, each bilateral arrangement requires its own 'rules of origin'. If there is a bilateral trade agreement with Mexico, we have to specify what a 'Mexican' product is. How much local manufacture does there have to be to qualify a product as 'Mexican'? Under the North American Free Trade Agreement (NAFTA), there were 200 single-spaced pages of rules of origin and 2000 pages overall![34]

Third, when everyone opens their borders at the same time, the gains are much larger and the adjustment costs much smaller. The benefit:-cost ratio is much higher. On political economy grounds, often it is the adjustment costs that prevent open markets, so multilateral approaches make better sense.

Finally, although the case for multilateralism is overwhelmingly about economic efficiency, treating all countries the same has a basic appeal to 'fairness', which has its own political attraction.

In summary, for international markets to work well and deliver what people want, we need rules, agreement about those rules and a market orientation where market forces dictate which good or service comes from which best source – all delivered from a competitive, open multilateral system.

An open, rules-based multilateral trading system provides:

> a stable institutional environment in which private enterprises know where they stand vis-à-vis their governments, and the governments of other countries, so that they can make decisions of long-term significance, so that they can plan for expansion or if need be for adjustment. It is thus that the GATT, and now the WTO, facilitates economic growth and development.[35]

There is a sound case for the WTO. The next logical question is, in an ideal world, what would its objective be and what principles should it follow when devising a common set of rules?

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34 A Kruger, *International trade: what everyone needs to know,* Oxford University Press, 2020.

35 A Stoeckel, H Corbet and C Yeutter, *Opportunity of a century to liberalise farm trade: rapporteurs' report*, RIRDC, 2002.

CHAPTER 4

What should the WTO system do and how?

Without a clear, simple purpose, let alone the means to achieve it, there will never be agreement on the reform of the WTO system. In a world of sovereign nation-states, agreement through international cooperation is the only way to successful global governance.

Things have changed hugely since the establishment of the GATT in 1947. Back then, the issues were the need to avoid a future world war, and for countries to stop pursuing beggar-thy-neighbour policies, such as currency devaluations, to promote their own trade. The original mission of the multilateral trading system was to enhance growth to achieve stability and support peace.

Now, although the imperative for world peace may well return and shouldn't be taken for granted, the issues and politics are different. Rising incomes (and the unequal rise of incomes within and between countries) plus the weight of economic growth and population, which puts pressure on the environment, have seen a host of other issues emerge. Different nation-states have different priorities. Technology, especially in transport, communications and digitalisation has grown rapidly. Trade in services has risen faster than trade in goods and the barriers to services (around three times those for goods) are found in behind-the-border regulations and standards such as licences. While trade and finance flows have flattened, digital flows have risen enormously.

As incomes rise, there are new demands in democracies for the trade rules to address inequality, child labour, human rights, climate change, wildlife protection, economic development, fairness, inclusivity, data flows and security of employment. The list goes on and on. Each issue is important, and worthy of fixing if the benefits exceed the costs. A starting point for what the global community finds important is the 17 UN Sustainable Development Goals.[36]

So what should the WTO system be achieving?

Purpose of the WTO system

The G20 correctly identified reform of the WTO system as important. G20 members were asked, 'How can the multilateral trading system be used to advance our shared objective of promoting growth, productivity, innovation, job creation and development?'[37] In the Riyadh Initiative, they state that the objective of the WTO is 'to realize a free, fair, non-discriminatory, transparent, predictable and stable trade and investment environment, and to keep our markets open'.[38]

But what is the purpose of 'non-discrimination'? It is to encourage competition to enhance incentives to innovate, be more productive and offer better value products and services to customers, thereby promoting growth. And what is the point of 'predictable'? It is to reduce uncertainty, lower risk, encourage investment and promote growth. Keeping 'markets open' lowers barriers to commerce and enhances predictability, encouraging more economic activity and promoting growth.

Everything in the WTO objective statement refers to the means by which growth is achieved. These are the things 'to do' to get the desired outcome of promoting growth – as in the original question posed to members. The original question posed to G20 members would have made a better objective than the one they adopted. Even then, the word 'innovation' in the question amounts to more 'productivity', which, in turn, means 'more is produced from less', which amounts to growth. The same can be said for the word 'development'. Since growth creates jobs, in effect, the implied G20 Riyadh Initiative on the purpose of the WTO is simply 'to promote growth'.

What is wrong with that objective? The problem is that 'growth' can be promoted by adding more people or running down a resource

36 United Nations, *Transforming our world: the 2030 Agenda for Sustainable Development*, United Nations. https://sdgs.un.org/2030agenda

37 G20 Information Centre, *G20 Trade and Investment Ministerial Meeting.*

38 G20 Information Centre, *G20 Trade and Investment Ministerial Meeting.*

or spoiling the environment, if the damage is not accounted for in the measure of 'growth' – typically the change in GDP. The body of the G20 communique correctly mentions the importance of implementation of the UN's Sustainable Development Goals, so the pursuit of these broader goals is implied in pursuing growth.

Rather than just pursuing growth, a better measure would be GDP per person or standard of living. The best and simplest objective for the WTO system would be:

> ***to ensure the international trading system gives each nation-state the best opportunity to improve its living standards, consistent with pursuing its sustainable development goals.***

It is important to note that 'living standards' is measured by GDP per person, but any national welfare measure can encompass employment and security of that employment. To test whether an objective is the right one, we can ask: 'If the WTO was successful in meeting its objective, what metric would we use to show this?' We can measure an improvement in living standards that has been achieved consistent with the pursuit of all desired sustainable development goals. If appropriate policies are in place to achieve other sustainability goals (for example, charges on pollution), market measures of living standards (GDP per person) will reflect social welfare. Where these social policies are absent, there are techniques for incorporating them in the measure of national interest.

Whatever the objective of the WTO, it should be measurable so that progress can be tested. This makes those responsible for delivering better outcomes accountable. Being outcome-focused makes it clearer where the failings might be, and focuses on what incentives need to change. As the old saying goes 'You can't manage what you don't measure.'

Principles to achieve the goal

Having determined that trade across borders has the ability to substantially lift living standards, while being consistent with sustainable development goals (if spillovers are properly dealt with), what means should be adopted to achieve this goal? The following discussion outlines a set of guiding principles.

Non-discrimination

Non-discrimination ensures competition from the widest group of suppliers, so that goods and services can be sourced at least cost, even if an import tariff or restriction is applied. It ensures foreign goods are treated the same as domestic ones, encouraging competition. Competition is one of the main drivers of innovation and productivity and is therefore the main spur to a more prosperous world economy. The principle of non-discrimination ensures that every nation-state, big and small, rich and poor, is treated the same, which appeals to 'fairness'.

Most favoured nation (MFN) is one of the core principles and a basic pillar of the WTO. Besides the competitive effect, it encourages compliance with trade rules. A WTO member wanting to raise tariffs has to do so against everyone, raising the costs to themselves. Therefore, MFN encourages stability in a country's trade regime. Of course, many problems arise in the real world as countries use loopholes and exemptions (such as national security) to get around the MFN clause. These loopholes need to be fixed. But most countries, especially those in the G20 and the WTO secretariat itself, would back the MFN as a core principle.

Openness to trade and investment

The fewer barriers to commercial exchange (whether within a country or across borders), the lower the costs, which leads to more prosperity. Openness to trade should be the default position of each country, and departures from this should only be allowed when it is in the national interest.

Communities are often fearful that they will be overwhelmed by trade and no longer able to compete, so they seek protection from their national government. However, economic studies have consistently shown that this is a fallacy. When nations are open to trade, investments are more prosperous.

Nations need to understand the costs and benefits of openness. But not all nations are able to do this, and may require outside assistance to undertake appropriate analysis to determine the correct policy settings. The OECD is an example of mutually supportive economic assistance. The World Bank and other development banks are also available and do assist in such processes.

Market-oriented

The exchange of goods and services across borders is mutually beneficial. Most exchanges are made on commercial terms. In general, the outcomes of commercial transactions should be based on market forces. Price, quality and delivery, not government decree, should matter.[39] When trade is strictly commercial, businesses know what the economics are. They can predict changes, assess risks and evaluate innovations. That leads to predictability and productivity. But when trade is based on state-owned enterprises whereby subsidies and favoured rules or standards can be politically conferred, often in hidden ways, it leads to an uncertain trading and investment environment that hurts business activity.

State-owned enterprises could still exist under this principle, provided they operated strictly on commercial terms, at arms-length from government.

Address global issues

There are many global issues that need our attention. Climate change (environment) and the COVID-19 pandemic (health and economic) are two of the most pressing issues facing the world now, but there are many others.

For each global issue, there is a best way that global governance arrangements should deal with it. For example, the WHO should have primary carriage of global health issues, oversight of vaccine distribution, health assistance for developing countries, quarantine standards and so on. If the WHO can't fix them, we shouldn't impose that responsibility on the WTO.

Bodies such as the IMF, OECD and G20 are the right ones to coordinate the global macroeconomic response to the pandemic. It is not up to the WTO – there is little it can do.

39 A Wolff, *DDG Wolff outlines possible responses to calls for WTO reform*, WTO, 13 January 2021. https://www.wto.org/english/news_e/news21_e/ddgaw_13jan21_e.htm

International cooperation

Members striking a multilateral treaty do so on a cooperative basis, as this is the only enduring mechanism that will ensure they adhere to the mutually agreed rules and codes of conduct out of their own self-interest. Trade (on any scale) will not occur without agreed rules. While countries are free to choose whatever regulation or standard they like on any matter (provided they treat foreign firms and domestic ones the same), they must recognise that harmonisation of standards and regulation can facilitate trade and lower costs. The WTO's Trade Facilitation Agreement is an example of this, and is widely held to be a major step forward.

Policy transparency

Trade barriers should only be imposed to address domestic concerns after a proper transparency process. Nation-states will act out of their own perceived national interest. For example, as we have seen, they may ban the export of vaccines if it is imperative that they do so to look after the health of their citizens, regardless of what agreements have been made.

However, often what is in the national interest is distorted and misguided by vested interests that dominate the public debate and misinform citizens about the true costs and benefits of a measure as they seek to manipulate the rules in their own narrow interests. And it simply does not make sense for citizens to do their own investigations – the benefit to themselves is too small and the costs too high.

For good policy in the national interest, the public need information and analysis they can trust, in a simple digestible form. They have to rely on an independent body doing the work for them. Proper process is required, and it must be independent, domestically done in national capitals, credible, transparent and economy-wide. Social and environmental goals that are not already internalised through policies can be costed and allowed for in the assessment of national interest. If an internal analytical capacity is not available, external and peer reviewed processes should also be applied.

CHAPTER 5

What has gone wrong with the WTO system?

Now that it is clear why we need a WTO, what it should do and how, we can begin to diagnose what has gone wrong with the WTO system. The demise of the WTO system has many origins: some old, some new.

The first set of problems stems from old flaws in the system, which were known but not corrected. It goes back to our first building block – a world of sovereign nation-states, necessitating compromise in setting agreed rules. These problems have been with us for some time. In 2004, I wrote:

> The mixed messages conveyed by mercantilist, discriminatory and protectionist ideas have led to confusion and muddled thinking about the framework of principles, rules and procedures – the 'rules of the road' – governing the conduct of trade policy. Without coherent principles and a set of conforming rules to guide 'due process', the way forward in liberalising international trade will be tortuous. The inconsistencies, loopholes and flawed rules plus mercantilist thinking are, like termites in the basement, gnawing away at the foundations of the WTO system. Unless fixed, at best we could witness the slow demise of the WTO system. At worst would be the disintegration of the system into a chaotic plethora of discriminatory trade arrangements, bilateral and regional, with trade conflicts breaking out all over – the very thing the multilateral trading system was formed to prevent.[40]

40 A Stoeckel, *Termites in the basement: to free up trade, fix the WTO's foundations*, RIRDC, Canberra, 2004.

These problems still need fixing.

The second problem is mission creep. A host of issues have crept onto the agenda of the WTO. Despite the legitimacy of these issues, a sovereign nation-state has only one tool – control over the commercial exchange of goods, services, capital and people across its borders. Agreeing to what disciplines on international exchange should be allowed and applied, and when, is what the negotiations of rules is about. But political demands mean the WTO system is being asked to do things it cannot achieve or is ill-suited to address. This problem goes far beyond the WTO. It has also permeated other organisations like the IMF and central banks, as well as private industry.

The third problem is that things change. The most dramatic change recently is the advent of the digital economy with the technology and communications revolution. Issues of data privacy, cybersecurity, standards on e-commerce and more have arisen, and it is not clear what should be done about them. Another area of changed thinking surrounds intellectual property and the global rules that should govern it. Difficult analyses and discussions are needed.

The fourth problem is the waning of a global leader that is willing to foster a coherent open multilateral trading system. The declining hegemony of the United States, culminating in the rejection of multilateralism by President Trump, has already been mentioned. This may be partly resolved under President Biden. Global leadership can help foster a better set of rules and more predictable open trade, and multilateralism can be strengthened by focusing the WTO system on its core business, with the world united around a single goal.

Let's look at these four problems in more detail.

A world of sovereign nation-states implies compromise in agreeing a set of rules

To get agreement between different nation-states, it is understandable that there will be compromise. One obvious way this happens is through writing exceptions or 'let out' clauses into the rules. These may seem innocuous at the time, but they can have serious effects over time.

There are five clear areas where flawed economics has led to a lack of coherence that has eroded the foundations of the multilateral trading system:

- preferential trade agreements
- safeguards and anti-dumping
- preferences for developing countries (including special and differential treatment)
- reciprocity
- dispute settlement.

These need some elaboration because it is not always obvious to policymakers what is wrong – hence the lack of adequate incentive to fix them.

Preferential trade agreements

The MFN principle underpins open, non-discriminatory trade that encourages competition, efficiency and innovation. It is a core foundation of the WTO system. Bilateral agreements are preferential and they contradict that principle. Bilateral or regional free-trade agreements weaken the MFN principle and undermine global, open, non-discriminatory trade.

The rush to form preferential trade agreements (PTAs) has led some trade experts to rank this among the most serious threats to the multilateral trading system.[41] To understand this problem and its solutions, it is necessary to know what these PTAs imply.

PTAs involve the selective removal of barriers to trade between a pair or group of countries. These agreements can take several forms, but they all have this in common: they are not free trade. They discriminate against trade with countries outside the group. Trade can be diverted away from the least cost source of imports, at a cost. When this happens, trade diversion outweighs the trade creation, so, unwittingly, a PTA can leave a country worse off. One study found that, of 18 PTAs examined, 12 had diverted more trade from non-members than they created among members.[42]

PTAs have other problems as well. 'Rules of origin' must be established, and these introduce a layer of regulation that is costly to monitor and enforce. Transaction costs can be higher as a result. Neither party to

41 Bhagwati, *Free trade today.*

42 R Adams, P Dee, J Gali and G McGuire, *The trade and investment effects of preferential trading arrangements – old and new evidence*, Productivity Commission Staff Working Paper, Canberra, 2003.

the agreement benefits from that. In fact, rules of origin regulations can become so onerous that most businesses do not bother with them, so the vast bulk of trade occurs under MFN negotiated tariffs!

On top of all that, PTAs also create perverse incentives. Once a preference is granted, an incentive is created to preserve that preference. This acts as a barrier to global reform. For example, if Mexico receives preferential access for sugar into the US market under a bilateral agreement, it has an incentive to block global sugar trade reform to preserve their preference – or, at least, not to argue for liberalisation of the world sugar market.

Another perverse incentive is the incentive for the preference receiver to push the extra competitive pressure onto third countries.[43] It does this by raising applied rates to bound rates, or by using non-tariff barriers, such as the selective use of safeguards, including anti-dumping actions. This 'endogeneity' of external barriers rising from the formation of a PTAs is a real risk.[44]

This issue has become more pressing because of the recent explosion of such arrangements. During the 1950s and 1960s, there were hardly any. Numbers rose through the 1970s and 1980s, but took off after 1990. By October 2003, 154 PTAs were in force and by 2021 there were 568 (Figure 8). This explosion of PTAs and the implications for the WTO system has trade experts worried.

Many reasons have been suggested for this swing to bilateralism. One is the fear of being left out, which is simply the narrow pursuit of individual interests in an uncoordinated fashion. No one country can prevent other countries from forming these agreements, so staying out of them means they run the risk of being discriminated against. Countries have no choice but to look after their own interests and join the game.

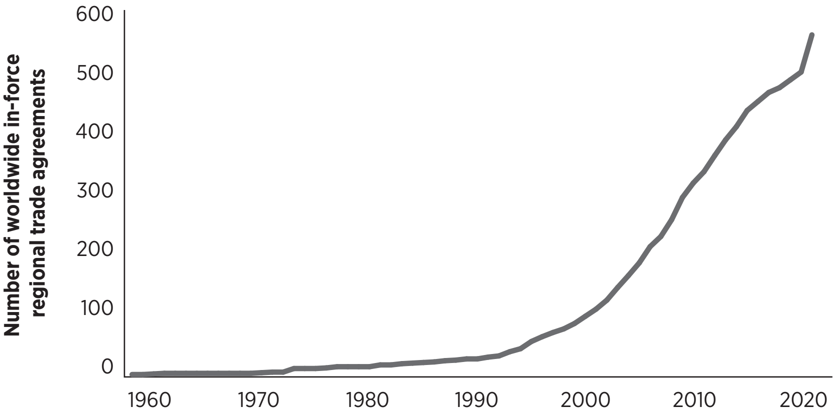
Another suggestion is that countries wishing to undertake multilateral trade reform do not want to be tied to the 'slowest ship in the convoy'. Although MFN free trade is vastly superior, the slowness of global talks and the desire of trade ministers to show gains have fuelled the stampede to bilateral and regional arrangements. Plurilateral agreements (discussed later) overcome this issue.

Given the existence of GATT Article XXIV, which grants an exception to the MFN clause permitting PTAs to form, a powerful dynamic

43 Bhagwati, *Free trade today*, p 110.

44 Bhagwati, *Free trade today*, p 153, fn 22.

Figure 8: Worldwide trade agreements, 1958–2021



Source: WTO, Regional Trade Agreements database

has been created. The solution is multilateral. Either Article XXIV must be rescinded, or all countries must liberalise all trade on an MFN basis, or, at a minimum, multilateralise existing PTAs by offering best terms to all trading partners. This would render the rules of origin and PTAs redundant.

Safeguards and anti-dumping

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

These safeguards exempt WTO members from the rules governing trade liberalisation and bound tariff rates. The objectives of the safeguards stem from their diverse historical roots, but nearly all have one thing in common – they are not good economic policy. Some are downright wrong and one – anti-dumping – is blatant protectionism dressed up in a different guise. As Finger and Andrei observe, 'anti-dumping is ordinary protection with a good public relations program'.[45]

45 JM Finger and A Zlate, 'WTO rules that allow new trade restrictions: the public interest is a bastard child', paper prepared for the UN Millennium *Project Task Force on Trade*, 2003, p 3.

The reason the GATT contains these economically flawed safeguards boils down to politics and that old fact of life: sovereign nation-states. Rather than jeopardise a whole liberalisation program, 'let out' clauses are negotiated to provide political comfort. Despite different justifications, all the safeguards have the same intent – protection – and the economics behind them can be remarkably similar. The most frequently used safeguard is anti-dumping.

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

There are two problems here. One is administrative, the other is economic. The administrative problem is that a 'normal value' must be established for the goods when they are sold in their country of origin. The dumping test simply asks, 'Is the imported good being sold at less than its normal value?'

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

... anti-dumping legislation is lousy economic policy.

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

Dumping of foreign goods in an importing country has two effects. One is the cost to a local producer, who must now compete with the cheaper imports. It may injure the local producer's sales and cause it to lay off workers. This has negative ripple effects through the economy. The second effect is the benefit to consumers. Consumers, whether households or other firms, have access to cheaper goods. These savings allow them to spend their money elsewhere. This has ripple effects too, but this time they are positive, such as generating jobs elsewhere.

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

This combination of an economically biased assessment and administrative fluidity in determining 'normal value', especially for economies in transition such as China, make anti-dumping the protective weapon of choice. Other problems exist, too. Anti-dumping is wound up in arcane legal text and procedures that few people understand, apart from specialist lawyers. There is also a complete lack of transparency, because the results of determinations are often not made public.

None of this is new. The intriguing thing about anti-dumping laws is that they have persisted for so long in their present form, despite being obviously counter to the national interest. The 'unfair' competition label is so strong that a public relations campaign to justify imports duties wins the day.

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

But there is an easy solution to remedy wrong anti-dumping policy. Assess both the benefits and the costs of dumping claims. Predatory pricing to drive out a local producer will show up in the cost-benefit test. Also, the administrative difficulty of determining 'normal value' in

To remedy wrong anti-dumping policy, assess both the benefits and costs.

dumping claims will be neutralised. If an artificially low 'normal value' is struck to show dumping, the costs to local producers will be greater, but so will the benefits to consumers. The incentive to inflate the calculation of dumping margins is removed when consumer benefits are included in the assessment of injury. Another advantage of cost-benefit tests is that economics is reintroduced into trade policy and the legalism that has crept into the WTO system is de-emphasised.[46]

The other safeguards in the GATT/WTO would also benefit from the same treatment. There should only be one safeguard provision in the WTO, rather than the current plethora of articles. That provision would allow protection of a domestic industry only if the country concerned first conducted an open, transparent and independent economy-wide analysis of the benefits and costs of intervening in trade.

Preferential treatment for developing countries

The issue of developing countries looms large in trade policies, and for good reason. The need for development and poverty alleviation is ongoing, despite massive progress over the last two decades. Successful development also means harnessing the gains from trade.

Developing countries have often raised the concern that their exports to advanced economies face higher tariffs than exports from other advanced economies do. For example, France's exports to the United States are more than 10 times those of Bangladesh, yet both pay the same amount of tariff (Box 2).

Under the Uruguay Round of negotiations, the tariff reductions that OECD countries offered to other OECD members were much greater than those offered to non-OECD countries. That is partly because developing countries offered less access to imports, so they received less in return. This is yet another example of how poisonous 'exports are good, imports are bad' thinking is. The result is that the trading system looks unfair, so developing countries look for preferential treatment.

46 The problem with an overly legalistic approach to trade policy has spilled over to the dispute settlement system, making it unworkable. This is discussed in more detail later.

Box 2: Bangladesh faces higher tariffs on exports to the United States than France

France's economy is three times bigger than the economy of Bangladesh. French exports to the United States are more than 10 times those of Bangladesh. This is partly due to the size difference, partly a result of being closer to the United States and partly because France, as an advanced economy, produces many of the things wanted by US consumers.

But, as shown in a trade study by Ken Heydon, 'Bangladesh is charged the same amount of tariffs (around $300 million) on its two and half billion dollars of exports to the United States as France, whose exports are $30 billion.'

On average, developing countries face larger barriers on their exports to OECD economies than other OECD economies do on their exports to OECD partners.

Source: K Heydon, *The political economy of international trade*, Polity Press, Cambridge, 2020.

However, preferential treatment to developing countries has not always worked to their benefit and has sometimes made matters worse. Indeed, in 2020, former US Trade Representative Robert Lighthizer asserted 'countries with large or advanced economies should not have access to special and differential treatment'.[47]

One study found that preferences do not achieve their aims. They end up 'encouraging high-cost production and transfer little benefit to developing countries'.[48] All too often, it was found, transferring aid via trade preference to some developing country ended up costing another developing country. Worse, in one case study, preferences for Mauritius sugar left the country worse off – the preferences were a 'kiss of death'.[49] Part of the problem is that developing countries are typically reliant on agriculture, which is a sector that remains one of the most distorted on world markets.

Development is a complex subject. It involves many elements, including institutional capacity building. Although it is an appealing idea

47 R Lighthizer, 'How to set the world straight', *Wall Street Journal*.

48 A Stoeckel and B Borrel, *Preferential trade and developing countries: bad aid, bad trade*, RIRDC, publication no. 01/116, 2001.

49 Stoeckel and Borrel, *Preferential trade and developing countries*, p 34.

to aid developing countries via preferential trade, the question remains whether the distortions to incentives this creates are in their interests. Preferences have been shown to encourage rent-seeking behaviour, create vested interests that block reform, hinder competition policy and distract policy attention from the main game of development.

Like PTAs, discussed earlier, preferences weaken the fundamental principle of the WTO – non-discrimination. The idea that all preferences should be dropped needs to be put squarely on the table. We must refocus on determining the best way to help poorer countries secure development. The World Bank has the obvious expertise to address this question, and it could easily bring in other worldwide expertise.

Reciprocity

Reciprocity has always been a basic inclusion in trade negotiations. The notion is that both sides of a negotiation walk away with something of comparable value. Reciprocity was used because it made good politics, even though it is based on flawed economics. During trade negotiations, negotiators believe that they are offering up a concession in exchange for access (or something else of value) to another country's market. By granting this access in exchange for removing a tariff on imports, powerful political forces are brought into play. The interests of the exporters, who stand to gain, are pitted against the interests of producers in import-protected industries, who resist liberalisation. The 'jobs will be lost' argument made by local producers who are competing with imports is offset by the argument from local exporters that 'jobs will be created'. In the past, reciprocity changed the political balance and made liberalisation more politically possible.

However, reciprocity is not working now, for two reasons. One is that reciprocity is a dangerous political game. It sends out the wrong message about trade liberalisation. The mistake is that a country reducing its barriers to trade is not offering a concession at all – they are doing themselves a favour! They are the gainers, not the losers, as the case for free trade is a unilateral one. The other reason is that the political forces that could be brought into play to help secure liberalisation are now no longer there. Successive liberalisation of goods trade (agriculture being an exemption) has meant most of the obvious trade-offs for so-called concessions are not there. What

... reciprocity is a dangerous political game

is left to negotiate over are difficult, opaque, behind-the-border barriers in services that are hard-to-measure and non-tariff barriers that are not obvious to 'trade'.

Reciprocity is not necessary for negotiations to work. For example, global rules on capital controls on banks for financial stability are not negotiated on a reciprocal basis. Perversely, reciprocity encourages countries to 'keep negotiating coin', even when doing so is not in their interest.

The puzzle is that the problem of lousy economics behind the concept of reciprocity has been well known for some time. For example, a study by Viravan and others in the late 1980s found 'the emphasis on reciprocity misinforms and mis-educates everyone (including trade officials) about the basic argument for liberal trade'.[50]

The problem is that reciprocity sets up a game scored by mercantilist rules: an increase in exports is a victory, but an increase in imports is a defeat.[51] Reciprocity fuels the 'exports are good, imports are bad' message. If the public wrongly believes imports are bad, politicians will find it harder to liberalise trade.

But it is even worse than that. Reinforcing the message of 'exports are good, imports are bad' lures policymakers into the false notion that they can inflict 'pain' on another country by threatening to block their exports. All they are doing is hurting themselves. They wrongly think they can demand something from another country, such as better labour standards, environmental outcomes or human rights. It encourages 'mission creep', the weaponisation of trade, political interference in another nation-state's affairs and resentment. In short, it creates an adversarial environment, which is the antithesis of global cooperation – the only basis for effective global governance. It also lures policymakers into the mistaken belief that retaliation is an effective discipline to enforce international trade rules in a dispute, when the opposite is true.

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50 A Viravan, *Trade routes to sustained economic growth: report of a study group of the Trade Policy Research Group*, MacMillan Press for the United Nations, London, 1987, p 136.

51 P Krugman, 'What should trade negotiators negotiate about?', *Journal of Economic Literature*.

Dispute settlement

The dispute settlement system is currently not working. The United States has blocked appointments to the Appellate Body, which is now not functioning. To understand these issues, we first need to do some backtracking.

The dispute settlement mechanism and enforcement arrangements introduced into the WTO as part of the Uruguay Round agreement is often hailed as a success. In many respects, it was a major advance on previous dispute settlement procedures, but it was flawed.

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

There is a second stage – an appeal avenue to the standing Appellate Body, another Uruguay Round initiative. If the Appellate Body agrees with the panel's final report, the member affected must implement the report's recommendations or pay compensation.

The United States has concerns about the Appellate Body. In 2020, former US Trade Representative Robert Lighthizer reported:

> Specifically, the Appellate Body has added to U.S. obligations and diminished U.S. rights by failing to comply with WTO rules, addressing issues it has no authority to address, taking actions it has no authority to take, and interpreting WTO agreements in ways not envisioned by the WTO Members who entered into those agreements.
>
> This persistent overreaching is plainly contrary to the Appellate Body's limited mandate, as set out in WTO rules.[52]

On a more fundamental level, there are two inherent problems. The first problem revolves around deciding when the rules have been

52 Office of the United States Trade Representative, *USTR report on the Appellate Body of the World Trade Organization* [media release], 11 February 2020. https://ustr.gov/about-us/policy-offices/press-office/press-releases/2020/february/ustr-issues-report-wto-appellate-body

broken. Its origins lie in the need for consensus when setting international rules, and the difficulty and time required to get consensus from member states. Consensus requires both diplomacy and language that is sometimes ambiguous so that all parties can agree to it. But dispute settlement requires that these ambiguities be clarified. This has turned the dispute settlement mechanism into a lawmaker rather than an interpreter of law. Claude Barfield, a former consultant to the office of the US Trade Representative, argued years ago that the 'judicialised' WTO dispute settlement system was substantively and politically unsustainable because of the logic of international law and the need for cooperation and consensus for international law to work.[53]

The second problem concerns enforcement of the WTO's rules. Enforcement mechanisms are sanctions and retaliation procedures permitted under the WTO's institutional arrangements against members that break the rules. These mechanisms are based on faulty economics, just like the notion of reciprocity. A country imposing sanctions on another hurts itself. Small countries cannot afford to retaliate when disputes are ruled in their favour. Yet one of the pillars of the multilateral rules-based trading system is that it should protect the small and weak against the strong.

...legal disputes are perceived as win–lose but trade is win–win.

Basically, legal disputes are perceived as win–lose but trade is win–win. Here lies the main remedy. Remove the excessive reliance on legalism and the win–lose mentality of the dispute settlement process by conducting a formal cost-benefit analysis (allowing for all secondary effects) of the contentious issue. This analysis must be fully transparent. Since the economics of trade is win–win, a cost-benefit analysis of the issue under dispute will encourage mediated outcomes that benefit both parties, potentially avoiding costly trade wars and saving legal costs.[54]

WTO members will obviously advance reform ideas for dispute settlement and, if the domestic transparency outlined above is not deemed sufficient, any reforms should meet the criteria of being simple, quick, efficient and effective.

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53 CE Barfield, *Free trade, sovereignty, democracy: the future of the World Trade Organization*, Washington DC, 2001, p 7.

54 Stoeckel, *Termites in the basement*, p 50.

Lack of domestic transparency

A final error leading to an ineffective WTO system is the lack of a suitable domestic transparency facility to assess what is in a nation's self-interest. A trade policy review mechanism (TPRM) was established as part of the WTO's basic functions in 1994. The problems are what it does, how and where. The trade policy review mechanism does provide information on a WTO member's trade policies, but that is only one small part of a proper transparency analysis. The missing ingredients are:

- the *effects* of a barrier to trade
- *how* these effects are assessed
- *where* the assessment is made.

To make an intelligent choice on policy, a nation-state needs to know what is in their national interest. They cannot act in their national interest if they don't know what it is! An assessment of the economic effects of trade barriers is not made by the TPRM, let alone by using economy-wide analysis that is independent and credible. In addition, the reviews are done in Geneva and many members resent this outside scrutiny. Some have suppressed the findings in their own country.

The trade policy review mechanism process has long been recognised as beyond repair. As a former Chairman of Australia's independent transparency agency, Bill Carmichael, said:

> The TPRM is perceived, especially by developing countries, to be beyond repair. It cannot now be turned into an agent of domestic reform. The WTO charter recognises that the sovereignty of individual member countries is absolute and inviolate. For that reason, ownership of the domestic process must reside, and be seen to reside, where responsibility for future progress in liberalising world trade now rests – in the domestic policy environments of individual countries.[55]

A comparative study of transparency institutions across key countries found the following:

> The WTO's Trade Policy Review Mechanism is the poorest of all transparency exercises of trade policy. Trade policy reviews contain no economic analysis at all – let alone economywide analysis. Since

55 B Carmichael, *Trade policies at the cross-roads*.

> the effect on national interest from each country's trade policy is not evaluated, there is no indication of what policy changes would be in the national interest. Also, trade policy reviews may not be perceived as being fully independent … Trade policy reviews conducted under the auspices of the WTO therefore have had no material effect on the quality of trade policies.[56]

Trade is ultimately about domestic competitiveness and driving productivity through innovation. Trade is mutually beneficial and both parties gain from the exchange – otherwise it would not happen! It is in the interests of all parties to abide by agreed rules and codes of conduct. The more obvious it is to a nation-state that departing from an agreed rule or introducing a new barrier to trade is not in their own self-interest, the greater the compliance and the more open the trade. In a world of nation-states where there is no international government or global police force, international law works by countries acting in their own self-interest.

This assessment has to be publicly credible and believable, so it is not captured by narrow vested interests. Yet, even in democracies, this *proper* assessment of national interest rarely happens. Countries do not always act in their national interest, because they don't measure it. As outlined above, this must be done through a proper domestic transparency process.

'Transparency' here means more than just transparent information about barriers to trade. It also encompasses transparent analysis – in other words, what is the *effect* of the trade barrier? Is the barrier a good thing or bad thing? And this analysis has to be believed by all domestic stakeholders, including the public to whom the government is accountable. That means independence, credibility and accountability.[57.]

There are many reasons for the demise of the WTO system. One common factor is misunderstanding of the benefits of open trade. Some level of misunderstanding is inevitable, but it is fuelled and reinforced by politicians who pander to poor policy prescriptions by sending the message that imports are bad. There is a way through this: appeal to self-interest by assessing it. The trick is that this assessment must be

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56 A Stoeckel and H Fisher, *Policy transparency: why does it work, who does it best?*, RIRDC, Canberra, 2008.

57 Stoeckel and Fisher, *Policy transparency.* See also the appendix in this report for a description of the elements of 'proper process'.

done in a way that ensures the public trust the findings, and the politicians who make decisions on policy must be accountable.

The special features of this transparency process are elaborated in the appendix to this report. Remedying this one step on proper domestic transparency process could improve trade policy globally. It is essential for a rules-based system to work in a world of sovereign nation-states that act in their own self-interest. Yet this step is not mentioned by the G7 or G20 in any of their prescriptions on improving the global trading system.

The gains from developing a domestic transparency institution based around a better process for setting trade policy may be even greater than just improved trade policy outcomes. A smart person might ask, 'If such an institution was set up to evaluate the costs and benefits of trade policy, surely it could also examine and advise on other areas of domestic economic policy?' In response, I would have to say,' You are a very smart person.'

It is not as if there is no analysis of trade policies now. Organisations like the World Bank and the OECD conduct these studies, as do many governments.[58] On top of that, there is excellent analysis by think tanks. There is ample experience with cost-benefit analysis in some countries. For example, the requirement to assess costs and benefits of regulations that started with President Reagan was described by Cass Sunstein as a 'revolution'.[59] But as Sunstein acknowledges, not all federal agencies are required to conduct cost-benefit analyses, although some do assess policies. Sunstein also discusses the many criticisms of cost-benefit analysis, most of which can be overcome. The requirement that all trade policies should be subject to a domestic transparent national interest test is not a big ask for many countries.

Mission creep

The phenomenon of mission creep, where the agenda of items to be 'solved' grows and grows, is not confined to the WTO. It is also apparent at the IMF, central banks and public companies, so it is worth

58 For a review of bodies assessing the costs and benefits of policies, see Stoeckel and Fisher, *Policy transparency.*

59 Cass Sunstein is a former Administrator of the US Office of Information and Regulatory Affairs. See his book on cost-benefit: CR Sunstein, *The cost-benefit revolution*, MIT Press, Cambridge, 2018.

looking at it more detail. Here is one account of the problem at the IMF by economist and journalist, Judith Sloan:

> The International Monetary Fund has a narrow role in ensuring the stability of the international monetary system. But its mission has exploded in recent years, with mission creep being common in government agencies.
>
> It now wants to impose 'smarter fiscal policies that can reduce inequality by striking the right balance between growth, debt sustainability and social protection'. These days, it's about inclusive growth, 'appropriately calibrated structural reforms' to boost productivity, tackle corruption, climate change, technological change and reforming international trade rules. It's hard to think of an economic or social policy area the IMF doesn't regard as worthy of its advice or interference.[60]

Economist John Cochrane describes the problem of mission creep at the European Central Bank, whose job is specifically to control inflation:

> If the ECB crosses this second Rubicon [climate change] – buying sovereign and corporate debt was the first – be ready for more. The IMF is already pushing redistribution. The US Federal Reserve, though it has so far stayed away from climate policy, is rushing into 'inclusive' employment ansd racial justice. There are many problems in the world. Once you start trying to shape climate policy, and so obviously break all the rules to do it, how can you resist the clamor to defund, disclose, and subsidize the rest? How will you resist demands to take up regional development, prop up dying industries, subsidize politicians' pet projects, and all the other sins that the ECB is explicitly enjoined from committing?[61]

Climate change is a potential risk and can impinge on financial markets. But there are many other risks of a shorter-term nature that can potentially impact on the stability of financial markets, so why not give these prominence as well? One difference is that policies to successfully address climate change will have large macroeconomic impacts and will

60 J Sloan, 'Illusion of control prompts a mission to public disaster', *The Australian,* 3 February 2021. https://www.theaustralian.com.au/commentary/illusion-of-control-prompts-a-mission-topublic-disaster/news-story/24a5d1df8a4a861689f3c117807778e0

61 J Cochrane, *Central banks and climate: a case of mission creep*, Hoover Institution, 2020.

require the right macroeconomic response from central banks as well as fiscal authorities.

The issue of mission creep has found its way into the boards of private business. Environmental, social and governance (ESG) investing has become important. Some of this can be useful, as boards assess public demand for their products or services and seek to position their brand as being preferred. This can result in a market-based solution to a social or environmental issue. For example, an egg producer may realise consumers are concerned about the welfare of chickens and are willing to pay a premium for free-range eggs, and produce accordingly. Of course, a standard for what 'free-range' means must be set to ensure the integrity of the label. Sustainably caught fish and sustainably harvested timber can now be purchased in many countries, all appropriately labelled. And there is nothing wrong with insisting that imported product meet that same standard as domestically produced products. This is the national treatment clause.

But environmental, social and governance investing raises its own problems. The system can be gamed. In March 2021, Tariq Fancy, the former chief investment officer at BlackRock, wrote this in an article in the media on 'greenwashing' by Wall Street:

> As the former chief investment officer of Sustainable Investing at BlackRock, the largest asset manager in the world with $8.7 trillion in assets, I led the charge to incorporate environmental, social and governance (ESG) into our global investments. In fact, our messaging helped mainstream the concept that pursuing social goods was also good for the bottom line. Sadly, that's all it is, a hopeful idea. In truth, sustainable investing boils down to little more than marketing hype, PR spin, and disingenuous promises from the investment community.[62]

Fancy went on to argue that, to achieve sustainable goals, government rules had to explicitly address desired goals.

For each environmental or social problem, there is a first-best policy that should be pursued. A market-based solution – like boards positioning their brand as having a feature that is attractive to consumers

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62 T Fancy, 'Financial world greenwashing the public with deadly distraction in sustainable investment practices,' *USA Today*, 16 March 2021. https://www.usatoday.com/story/opinion/2021/03/16/wall-street-esg-sustainable-investing-greenwashing-column/6948923002/

– can be helpful but, as Fancy describes, these can be mostly 'smoke and mirrors', leading to a dangerous distraction. Clear, direct, transparent, first-best policies can achieve more at lower cost.

In a world of nation-states, trade policy gives a government only one instrument: the control of goods and services across its borders. As the saying goes, 'You can't kill two birds with one stone'. This is more formally expressed in Nobel laureate Jan Tinbergen's fundamental principle: for policy to work, there must be as many independent effective instruments as there are feasible targets[63]. If you are pursuing 10 targets, you need 10 independent instruments.

To be effective, any policy instrument should be as closely linked or assigned to the policy objective as possible. Part of the problem of the current WTO system, as will be seen later, is that the agenda has become too big. The WTO is being asked to achieve things it is ill-suited to achieve, if at all. That leaves stakeholders dissatisfied with the system, which then falls into disrepute.

The purpose of the WTO system is to facilitate the commercial exchange of goods and services across national borders so that the world can prosper. And even if all international trade disappeared tomorrow, the issues of child labour, inequality, sustainability and more would still exist in some economies unless they are addressed by domestic policies. Trade is just one part – a valuable one – of all economic activity.

We get the most remediation of an economic, social or environmental issue at least cost by using the best tool at hand. The best tool may be a domestic policy change, support by a UN agency, the World Bank, the IMF or one of many other international forums.

There is a burning need to concentrate the WTO system on its core business. That way it is more likely to succeed and rebuild trust in the institution.

Climate change and carbon border adjustments

Climate change is a serious global issue, and therefore it is an area of mission creep that deserves attention. Primary carriage is through the UN's Intergovernmental Panel on Climate Change (IPCC) and Conference of the Parties (COP), where all nations are represented within the existing UN system.

63 J Tinbergen, *Economic policy: principles and design*, North Holland, 1956.

Since the problem is global, the task is threefold:

- to strike an agreement across the nations on the level of net carbon emissions by a certain time to constrain global warming to an 'acceptable' rise (the *objective*)
- to devise a policy to get the most reduction in global emissions at least cost (the *efficiency* means)
- to build in redistributions for poorer countries to ensure their participation in this major policy shift, which will result in large changes in gainers and losers (the *equity* means).

It is well known that there is too little agreement worldwide on these aspects. The Paris Agreement is a binding agreement for all nations to 'undertake ambitious efforts to combat climate change'. But 'ambitious efforts' means different things to different countries. Countries in which domestic politics demand more aggressive action than others risk businesses going offshore to a higher-emitting country. These businesses will then import their goods, and there will be no overall reduction in carbon emissions. To deal with this carbon 'leakage', a carbon border adjustment has been proposed, principally by the European Union. The border adjustment would be the imposition of a tariff (tax) on imports of emission-intensive goods, such as steel or cement, from countries that do not have an effective price on carbon within their economy. That sounds sensible. What could be wrong with that?

Carbon border adjustments are a second-best policy. First-best policy is one where all countries adopt the 'right' carbon abatement policy, accompanied by adequate redistribution policies. This is what is needed to lower global net emissions at least cost and make the best possible progress. In this situation, there would be no need for carbon border adjustments.

A carbon border adjustment policy introduces other problems:

- It risks reducing the incentive for governments to pursue a first-best policy.
- It would be extremely difficult to administer and trace the carbon content of imports, especially those that have complicated supply chains.
- It is likely to achieve little by way of climate change. Domestic economic activity accounts for the bulk of carbon emissions in most economies.

- Carbon border adjustments could be captured by protectionists using the policy as a guise to keep out imports for their own benefit. If so, it would fly in the face of the UN framework agreement on climate change that explicitly calls for mitigation measures not to be used as disguised restrictions on trade. Developing countries might cry 'foul'. Retaliation and tension may be the unintended result at a time when cooperation is desperately needed.

Second-best could easily end up being fourth-best!

James Bacchus, a former Appellate Body judge, has argued for a WTO climate waiver (a temporary exemption to comply). In his view, there is a looming collision between the frameworks of rules of the WTO and COP that need sorting out.[64] The primary purpose of the COP26 meeting in November 2021 is to address global climate policy, and a first-best policy should be given a chance.

A pessimist might argue that, based on achievements so far, that chance is small, but the world is changing in its attitude to pricing carbon emissions. The recent G20 finance ministers meeting endorsed carbon pricing as part of a suite of measures to tackle climate change. Business will realise that a global carbon pricing route is better than going down the futile 'rabbit hole' of emissions disclosure that Nobel laureate William Nordhaus describes.

> The movement to have companies measure and disclose their emissions is just an enormous waste of time. If you had a proper price on carbon, we wouldn't have to do that anymore than we need companies to do an inventory of their wheat use or silicon use. It's another example of how we're going down a rabbit hole of measures. Even the central banks are getting involved.[65]

In the event of lack of meaningful progress at COP26, the world will probably gravitate to what Nordhaus describes as a 'climate club' of countries willing to adopt a carbon price,[66] along with an emphasis on supporting low-carbon technologies and necessary infrastructure. In this world, there would be a role for a carbon border adjustment to

64 J Bacchus, *The case for a WTO climate waiver*, Centre for International Governance Innovation, 2017.

65 S Mufson, 'Nobel winner's evolution from 'dark realist' to just plain realist on climate change', *Washington Post,* 14 June 2021.

66 WD Nordhaus, *The spirit of green: the economics of collisions and contagions in a crowded world*, Princeton University Press, 2021.

address the free rider problem and prevent carbon leakage. In this scenario, where carbon border adjustments become widespread, it is to be hoped that early awareness of unintended consequences does not finally wreck the WTO system.

New areas

Digital economy

The biggest change over the last two decades has been the massive digital transformation, which affects every aspect of business and human interaction. As the OECD observed:

> Digitalisation has significantly reduced the cost of engaging in international trade; facilitated the co-ordination of global value chains; helped diffuse ideas and technologies; and connected a greater number of businesses and consumers globally. [67]

The authors also note that digitalisation has 'increased the scale, scope and speed of trade, posing new challenges for policymakers'.

Important aspects of digital trade are covered under the WTO's General Agreement on Trade in Services (GATS), but many bilateral and regional trade agreements cover digital aspects. The recent G7 meeting of Digital and Technology Ministers in April 2021 observed how these differences can 'impact crossborder data flows, creating uncertainty (including legal uncertainty) for governments, businesses and individuals'.[68] This has led to a potential benefit for small and medium-sized enterprises (SMEs), relative to the gain for large businesses. This is important, as small business are the engine room of most economies.

The digital revolution has given SMEs the opportunity to go global both for imports and exports. This is significant, because SMEs that serve domestic consumers need free access to imports in order to offer the best products and services to their customers. From cafes to gyms, these operators can improve their businesses by sourcing the best value-for-money inputs, whether they are local or global. The digital

67 JL González and J Ferencz, *Digital trade and market openness*, OECD Trade Policy Papers, no. 217, OECD Publishing, Paris. 2018. http://dx.doi.org/10.1787/1bd89c9a-en

68 G7, G7 *Ministerial Declaration: G7 Digital and Technology Ministers*, 28 April 2021. http://www.g7.utoronto.ca/ict/2021-digital-tech-declaration.html

revolution allows SMEs to reach millions of potential suppliers, but there are many hurdles for purchases across borders.

Likewise, the digital revolution allows SMEs to potentially reach billions of customers, vastly expanding their prospects for economic recovery via international trade. Former Bank of England Governor, Mark Carney, expresses it this way:

> … the time has come for free trade for small and medium enterprises. They are the engine rooms of most economies, yet they account for only a fraction of exports. A large part of this underrepresentation reflects the much higher costs of doing business across borders – from regulation to the costs of transferring money.[69]

Harnessing digital platforms can give SMEs the opportunity to globalise and help drive inclusive growth. Expanding international trade and increasing SME contributions from an import and export perspective has the potential to add enormously to the badly needed economic recovery. However, rules governing digital policy issues such as privacy and cybersecurity have not been developed or agreed and these must be a priority.

The issue is far broader than just trade. Again, as the G7 communique remarks, 'we are witnessing an increasing divergence of models, this transformation raises important questions about the interaction between economic opportunity, security, ethics, and human rights, and the balance between the role of the state, businesses and individuals'.[70]

The May 2021 G7 Trade Ministers' Communique notes that 'global digital markets must be open', that digital protectionism should be opposed and they 'agree on the importance of data free flow with trust', and 'welcome and support the OECD's work on digital trade and data flows'.[71]

Given the explosion of digital change, uptake (accelerated by the COVID-19 pandemic), and multiple suggestions for policy, it would make sense to ask the OECD to assess what the global digital rules might be and what the right institution might be to make the G7's communique operational.

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69 M Carney, 'A chance to reboot globalisation', *Financial Times*, 19 March 2021. https://www.ft.com/content/2d746e62-2810-4af7-9326-56102625a81b

70 G7, *Carbis Bay G7 Summit Communique, 13 June 13 2021.* https://www.whitehouse.gov/briefing-room/statements-releases/2021/06/13/carbis-bay-g7-summit-communique/

71 G7, *G7 Trade Ministers' Communique*, 28 May 2021. https://www.g7uk.org/g7-trade-ministers-communique/

Intellectual property

The digital revolution also has implications for intellectual property rules under the WTO. The digital revolution has made it far easier to create, copy and transmit knowledge, but it raises two questions:

- Is the incentive system that is in place for new knowledge creation still right?
- Is enforcement of those incentives under intellectual property rights globally now more difficult?

These questions are important, as new knowledge is the driver of prosperity in a more sustainable planet.

Intellectual property rights rules are within the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement made in 1995. Before that, global intellectual property arrangements were dealt with by the World Intellectual Property Organization (WIPO), a UN agency. As the WTO states:

> The TRIPS Agreement plays a critical role in facilitating trade in knowledge and creativity, in resolving trade disputes over intellectual property, and in assuring WTO members the latitude to achieve their domestic objectives.[72]

There are many criticisms of TRIPS. A big one is about the transfer of wealth from poor developing countries to more wealthy ones where much new knowledge is created. Rodrik argues this significantly impairs the ability of developing countries to reverse-engineer and apply advanced technologies used in advanced economies[73]. The global pandemic has brought the specific issue of patents covering medicines and vaccines to the forefront. Other criticisms surround the granting of geographic indications (such as the exclusive use of the word 'champagne' by the French) and whether that reflects something genuine about a trademark or amounts to protection.

Addressing all the criticisms of TRIPS would require a study in itself. At a fundamental level, the problem with intellectual property is a conundrum. New ideas can be transmitted virtually freely, and this enhances their adoption, enabling prosperity and progress. Ideas are

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72 WTO, *Intellectual property: protection and enforcement*, WTO. https://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm

73 Rodrik, *The globalization paradox: why global markets, states, and democracy can't coexist*.

non-rival 'goods' – their consumption by one entity does not stop another entity also consuming them. Ideas should be distributed and used as widely as possible. The problem is that there must be an incentive to produce these new ideas in the first place. Nothing can be consumed if it is not first produced. While governments have a role in developing new ideas (particularly basic research), practical innovations are risky and best handled by the private sector. The current system offers temporary property rights (such as patents and copyright) to the inventor to create the incentive to innovate. So, a balance has been struck, as reflected in the TRIPS Agreement developed a quarter of a century ago.

New arrangements on intellectual property have often been struck in regional and bilateral agreements. As well, different cultures among the nation-states have different attitudes to enforcement of these property rights. In the digital age, where knowledge can be more easily copied and transmitted, there is a need to revisit the 1995 TRIPS Agreement to test whether the alignment with various regional agreements ensures that the right balance between access to new knowledge and granting temporary monopoly rights has been struck. On top of that, there is the issue of how those rules will be enforced so that the incentive to produce new knowledge is not eroded. A rethink on intellectual property is warranted.[74] The OECD would be one organisation that could review intellectual property arrangements.

Decline of multilateralism and lack of effective hegemon

In the absence of a global government, world issues like open trade policies benefit from an effective leader who is willing to foster open markets along sound principles. In the post-WWII period, the United States has played much of this role, but not without their own 'lapses' on trade policy. Much has been written about the need for a global hegemon, mostly in terms of the need for geopolitical stability, peace and numerous areas for global cooperation.

Three features of hegemony are power, dominance and leadership of ideas. Being a global hegemon is part choice and part a consequence of

74 James Bacchus also argues cogently for such a rethink. See J Bacchus, *TRIPS-Past to TRIPS-Plus: upholding the balance between exclusivity and access*, Centre for International Governance, paper no. 254, 2021.

size. One natural development in the post-WWII period has been the rising importance of developing countries, and in particular, the dramatic rise of China. Developing countries now comprise over half of the world economy and emerging and developing markets could account for 60 per cent of global GDP by 2030 (adjusted for purchasing power).

The United States' share of global GDP has nearly halved since 1960. Even though the United States' economic dominance has waned with the rise in developing and emerging economies, it still ranks as a superpower in its ability to project military force. The decline in dominance by the United States because of its falling relative size can partly be overcome by forming coalitions of like-minded countries who can exercise hegemony as a collective. This is already happening. For example, the Ottawa Group (a small representative group of WTO members) is trying to advance the reform of the WTO.[75] But even forming coalitions works best when someone leads and takes the initiative.

It is the leadership of ideas aspect where the United States could influence the WTO system for the better, if it chooses to do so. Leadership of global institutions can be projected through better ideas with values and norms broadly respected by the bulk of the world's economy.

The multilateral trading system came under a new threat during President Trump's administration, whose instincts were to reject multilateralism. Indeed, during his candidacy and before his election, Trump aired the idea that the United States should pull out of the WTO. He embarked on an aggressive stance on trade relations, sparking a trade war with China in particular, involving tariff escalation and retaliation. President Biden has signalled a return to multilateralism but, although it is still early days at time of writing, there are few tangible results on trade.

Part of the decline of multilateralism, which involves all countries in the world, has to do with mission creep. Multilateralism is strongest when countries galvanise around a clear, simple purpose. Pursuing one unified goal strengthens the multilateral system. By contrast, a broad agenda where 'everything is on the table' weakens the commitment to multilateralism. Different countries with different cultures pursue different priorities. Focusing the WTO on core business would be important for re-establishing a well-functioning multilateral trading system.

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75 Global Affairs Canada, *Ottawa Group and WTO reform*, Government of Canada, 2019. https://www.canada.ca/en/global-affairs/news/2019/05/ottawa-group-and-wto-reform.html

CHAPTER 6

How can we fix the WTO system?

The institutional arrangements governing the world trading system needs reform. The G7 is right to call for 'root-and-branch' reform. Twelve steps are needed to make this reform succeed. They start with setting a clear objective, adopting the principles to achieve the goal, and then applying them to those areas where most attention is needed, both old and new.

Twelve steps for reform

Step 1: Adopt a common simple purpose for the WTO system

Without a clear, simple purpose, let alone the means to achieve it, there will never be agreement on reform of the WTO system. And in a world of sovereign nation-states, agreement through international cooperation is the *only* way to successful global governance.

The G20's Riyadh Initiative comes closest to an objective and set of principles that would work, but they are too complex, reflect 'drafting by committee' and succumb to mission creep. An objective for the WTO system should be outcome-oriented, so success can be judged by measuring the outcome.

The objective outlined in this report is simpler and clear and should be adopted:

> ***to ensure the international trading system gives each nation-state the best opportunity to improve its living standards consistent with pursuing its sustainable development goals.***

Step 2: Adopt and apply a set of principles to achieve the WTO's objective

To achieve the objective above, the means or principles to do this must be adopted. A set of rules surrounding openness, non-discrimination and multilateralism have to be agreed to. Exemptions to these principles should only be allowed if the intervention is in the national interest, as determined by a proper domestic transparency process. The principles would be:

> ***an open, non-discriminatory, rules-based, multilateral system where interventions in trade only occur where the national benefits exceed the costs.***

The interpretation of these words is given at length in the body of this study. In summary:

- 'Open' means no barriers to trade, except where national benefits exceed the costs (as determined by a proper transparency process).
- 'Non-discriminatory' means all countries are treated the same and foreign goods and services are treated the same as domestic ones.
- 'Rules-based' is important to lower risk of commerce across borders but it also means compliance is essential, which requires a proper domestic transparency process to assess the national interest.
- 'Multilateral' is more efficient and fairer and stands its best chance when the world galvanises around a simple, clear goal. It implies a hegemon (or group of countries acting as a hegemon) to give the leadership to adopt a clear goal and a set of principles to achieve that goal, and devise the rules to codify those principles.

Applying the principle of transparently assessing the national interest means trade sanctions have little role, as the case for free trade is a unilateral one. Sanctions are an appeal to domestic populations by politicians to show that they are 'doing something', even if what they are doing is ineffective.

The principle of intervening only if the national benefits exceed the costs will strip out many of the GATT/WTO Articles about exemptions. These exemptions are manipulated by protectionists. There are so many exemptions that 'anything goes'. This principle makes it clear that trade policy is domestic policy. It makes domestic politicians accountable for restricting trade that is not in the national interest, and elevates the importance of economics in what is, at heart, a commercial activity.

Applying those principles requires several steps, which are set out below, that contradict these rules. But it also means rejecting some existing wrong principles. One existing principle that is based on lousy economics and should be ditched is the use of reciprocity in negotiations. This should be rejected because it is lousy economics based on wrong mercantilist thinking of 'exports are good, imports are bad'. This has become a major block to trade liberalisation and will be partly remedied by adopting the next critical step.

Step 3: Establish a domestic transparency institution in each domestic capital to assess national self-interest from trade policies

This step is the most important reform that was discussed in the introduction to this report. It is new, and no-one else is currently proposing it, but is the one step that will lead to a more open freely trading world with less disputes. It is essential if governments are genuine about a rules-based multilateral trading system.

The logic is that there are gains from having rules to facilitate trade, but there is little point in adopting them if they are not adhered to. International rules are different to domestic laws, which are enforced by a legislature, judiciary and police force. In a world of nation-states, compliance with international law only works because it is in a country's self-interest to do so. That cannot happen if countries don't assess what is in their national interest. Few countries assess the benefits and costs of trade policy through proper process. Trade sanctions and retaliation to enforce compliance do not work because these policies are 'beggar-thyself'. A country imposing a barrier to trade primarily hurts itself.

For domestic transparency to work well, several interrelated elements have to be in place. These are outlined in the appendix to this report. The key words are 'independent', 'credible', 'economy-wide benefits and costs' and these transparency reviews must be done in domestic capitals, not Geneva.

Transparency of policy identifies the national interest, informs and educates the government and the public, exposes narrow vested interests and weakens their influence and helps build coalitions for reform. It changes the politics of protection. It also leads to a more predictable policy environment, as businesses have a fair idea what the costs and benefits of a trade measure are. A more predictable environment reduces uncertainty and encourages investment.

This step will be criticised as unrealistic, despite being proven to work as outlined in the studies cited earlier. It was proposed by an expert group reporting to the (then) GATT and by a working group led by a former Director-General of the GATT more than 30 years ago. But was never properly implemented as intended. It is the one step that could make a difference and is time to give it a go.

Step 4: Stop mission creep

As incomes have risen, there are new demands for trade rules to address inequality, child labour, human rights, climate change, wildlife protection, economic development, fairness, inclusivity, data flows, security of employment and more. Each issue is important, and worthy of fixing if the benefits exceed the costs, but 'you can't kill two birds with one stone'.

A sovereign nation-state only has one instrument: control of trade across its borders. There can only be one objective of the WTO system: to facilitate the commercial exchange of goods and services across national borders so that WTO members can prosper.

Control of commercial exchange across borders cannot achieve many of the aims the WTO is asked to achieve. Trade is just one part of all economic activity. We can get the most remediation of each economic, social or environmental issue at least cost by using the best instrument for the purpose at hand, whether it be a UN agency, the World Bank, the IMF or one of many others. If these agencies are not up to it, fix them or scrap them!

There is a desperate need to concentrate the WTO system on core business. This will make it more likely to succeed and will rebuild trust in the institution. Multilateralism works best when nations are united around a single clear goal. Multiple goals create differences, as different countries have different priorities, and this weakens the multilateral system. Setting up a domestic transparency agency will help strip out agenda items where the WTO is likely to have little effect.

Multilateralism works best when nations are united around a single clear goal.

One new area on the agenda that will be controversial is carbon border adjustments to address the issue of climate change. But this issue only arises if the world does not adopt first-best carbon policy. The world is shifting in its attitude to climate change. The COP 26 meeting in November 2021 should be given a chance to move towards a first-best global policy, removing the need for a carbon border adjustment policy.

Step 5: Multilateralise all preferential trade agreements

PTAs are discriminatory. Bilateral agreements with all countries is not the same as one multilateral agreement with market access offered on an MFN basis. Once a preference is given to a market, a 'rule-of-origin' has to be struck. These are complicated and often specific to a market. The original NAFTA agreement was 2,000 pages long, and a large slab was devoted to rules of origin. It is just more regulation and complication. Often a PTA is set up to avoid difficult areas of liberalisation, like agriculture, despite the current requirement that 'substantially all trade is covered'.

The existence of GATT/WTO Article XXIV granting an exception to the MFN clause and permitting PTAs to form, has created a powerful dynamic to form these bilateral and regional agreements. Countries have to join in if they are to look after their interests. Staying out of PTAs does not stop other countries from forming them. The solution is multilateral. Since it would be difficult to rescind Article XXIV upfront, the back-door remediation route is for all countries to offer their best terms from each PTA to all WTO members on an MFN basis. In effect, they would multilateralise their agreements. This would in effect render the rules of origin and the PTAs redundant.

Some barriers will come down as countries offer best terms to everyone. It makes PTAs better, it is non-discriminatory, it simplifies things and no rules of origin would be needed! PTAs would quietly become inoperative.

Step 6: Only permit subsidies that address market failures and externalities

Subsidies are often used to encourage domestic production in particular industries, and they can have important trade effects. Removing tariffs to liberalise trade may not have the desired effect if it is simply replaced by a domestic subsidy. A tariff works as the combination of a consumer tax and a hidden subsidy (transfer) to the domestic protected industry. Removing a tariff, but replacing it with a subsidy, simply removes the consumer tax component but leaves the distortion to the best use of a nation's resources in place.

A blanket ban on the use of subsidies would prevent the legitimate use of subsidies where the national benefits exceed the cost. But there are good and bad subsidies. Subsidies for vaccine production in the middle of a pandemic would qualify as 'good'. The solution is provided by the national self-interest test outlined in Step 3.

Step 7: Assess anti-dumping on both a cost and benefit basis

Anti-dumping cases are assessed on the injury caused to domestic producers of an item, but dumping often has benefits for consumers. A national self-interest test would look at both the costs and benefits and weigh up what action to take in the national self-interest. Strategic predatory pricing behaviour by a foreign competitor can be included in the assessment and is not a reason to ignore the national self-interest test. When we ignore what is in the national self-interest, a one-sided view prevails and rent-seekers game the system.

There is another gain from taking a balanced view of anti-dumping. As anti-dumping assessments are currently structured, injury is determined by finding the difference between the price of the imported product and the domestic price in the exporting country. If the domestic price in the exporting country is not determined in a market economy, the rules effectively allow any price (within reason) to be used. Injury can always be found and this can be used to justify a protective tariff. (Anti-dumping is the protectionist's weapon of choice.) But in a balanced assessment, if an artificially low price is chosen to bolster the case for anti-dumping duties, while it exaggerates the injury it also exaggerates the benefit to domestic consumers. A balanced cost and benefit assessment removes the incentive to game the system.

Step 8: Reassess differential treatment for developing countries

Preferences for developing countries have a natural appeal, as trade is an important driver of growth and development. But they are discriminatory, albeit in a well-intentioned way. As such they erode the non-discrimination principle, which, as in the case of PTAs discussed above, sometimes creates perverse incentives and unintended side effects. Some of the unintended side effects have been the creation of economic rents, often captured by wholesalers and others who are not the intended beneficiary. Also, they are a potentially wasting asset, their value declining with further liberalisation. In some cases they have distorted factor markets so much that they have become a 'kiss of death' for the developing economy. Finally, preferences can create a vested interest by the recipient country to block liberalisation of the product concerned in WTO trade talks.

Development for poor countries is one of the most pressing moral and economic issues of our time. But the problem of securing development is a multifaceted issue. It involves education, good governance, good institutions, capacity building, a thriving reliable financial sector and public infrastructure as well as openness to trade. Trade is just one part of the mix. By itself, trade policy is unlikely to secure development without good domestic policies. Studies have shown that unintended perverse outcomes can result from giving preferences without good domestic policies.

The effectiveness of preferences as aid to developing countries needs to be re-examined. We need to ask if there is a more effective way for advanced economies to deliver aid to developing countries. The World Bank has the required expertise in this area.

Step 9: Assess best arrangement for digital economy rules

The explosion in the digital economy over the last decade or so has been enormous. The uptake of digital technology has accelerated under the global COVID-19 pandemic as societies have been 'locked down' and working from home has become a norm. The ramifications are huge, touching virtually every aspect of commerce and human interaction. Besides e-commerce and electronic payments across borders – areas affecting international trade – there are issues of data privacy, cybersecurity, cyber-crime and interference in other country's democratic processes through social media.

Not all of these issues fall under the ambit of the WTO. The OECD has several initiatives in this area, and sorting out what polices should be put in place, how they should be addressed and by whom needs solid analysis.

Step 10: Reassess intellectual property

Knowledge is the fundamental driver of all human progress, so this is an important area. But there has always been a fundamental conundrum that ideas, once produced, are non-rival, so should be freely available. But there has to be an incentive to create of new knowledge. So far, this has been solved by giving limited-time property rights to inventors through patents, copyright and trademarks. Has the correct balance been struck?

A patent has to be disclosed so others can see and improve on it. However, alternative incentive systems do exist. For example, subsidies can be given for R&D or prizes awarded. One famous example of this is the prize set up by the UK Parliament in 1714 for anyone who could find a simple and practical method to determine a ship's longitude.

Alternatively, government does the innovation itself. Government has an important role in generating new knowledge, especially basic research, but this is not the complete answer. Innovation is costly and risky and there can be large losses, so private interests need to be harnessed. There is no 'right' answer to this conundrum but, in the digital world we are entering, the transmission of ideas and the ability to cheat and copy is easier. The WTO's TRIPS Agreement was made in 1995 and it should be re-examined to see if the right incentives exist in the inevitable trade-off that has to be made between the advantage of making inventions freely available and having to create a reward for the inventor.

Step 11: Redesign the dispute settlement system

The dispute settlement system is not currently functioning, due to the blocking of Appellate Body judges by the United States. Part of the problem is that the system gets gamed, but the bigger issue is that the Appellate Body is perceived as setting 'black letter' law, when the whole basis of the WTO is to cooperate and negotiate around setting 'rules of the road'. Fundamentally, it is not in a country's own interest to restrict trade. Good domestic transparency process of policy will remove the incentive to impose barriers to trade in the first place, so there will be fewer, if any, disputes.

According to its critics, the WTO dispute settlement system has become a lawmaker rather than a law interpreter. One solution is to insist on a simple, quick, efficient and effective dispute settlement or ditch it altogether.

Disputes should be minimal under a regime of 'enlightened self-interest', as described in Step 3. In the event of a dispute, it should be settled by a one-off negotiation of the contracting parties that is not binding on anyone else. There should be no 'black letter' law set by the Appellate Body, since the whole basis of an agreed set of rules or code of conduct in the first place was negotiation. The main objector to dispute settlement system is the United States, so they should come up with an appropriate solution that meets the criteria of simple, quick, effective and efficient.

Step 12: Allow plurilateral agreements only if they are open to all at a later stage

The problem with multilateral negotiations is that they can be held up by the 'slowest ship in the convoy'. Veto power (the 'single undertaking' model used within the WTO) can stall things further, as countries try and game the negotiations.

Plurilateral agreements should be permitted, even though they initially contradict the non-discrimination principle. The way around that potential problem is to make it possible for other countries to join later on the same terms. That is, we allow other countries to take advantage of the rules and standards that have been negotiated by leading nations who have the resources to work out issues like rules for digital trade and intellectual property.

The danger is that the world will split into competing blocks, based on different standards and rules. It looked like doing this over 30 years ago when the Confederation of Asian Chambers of Commerce and Industry commissioned an independent study to assess these risks and come up

Good domestic policy is the route to good trade policy.

with strategies to avoid them.[76] The success of that study to help a better outcome is behind the motivation for this study, again commissioned by CACCI.

Putting it all together

Undertaking these 12 steps would make a material difference to the world trading system. Good domestic policy is the route to good trade policy. The steps are interrelated and reinforce each other (Figure 9).

The first four steps are essential, and Steps 1–3 help achieve Step 4:

Step 1: Adopt a common simple purpose for the WTO system
Step 2: Adopt and apply a set of principles to achieve the WTO's objective
Step 3: Establish a domestic transparency institution in each domestic capital to assess national self-interest from trade policies
Step 4: Stop mission creep

Step 3 also helps Steps 5–8:

Step 5: Multilateralise all preferential trade agreements
Step 6: Only permit subsidies that address market failures and externalities
Step 7: Assess anti-dumping on both a cost and benefit basis
Step 8: Reassess differential treatment for developing countries

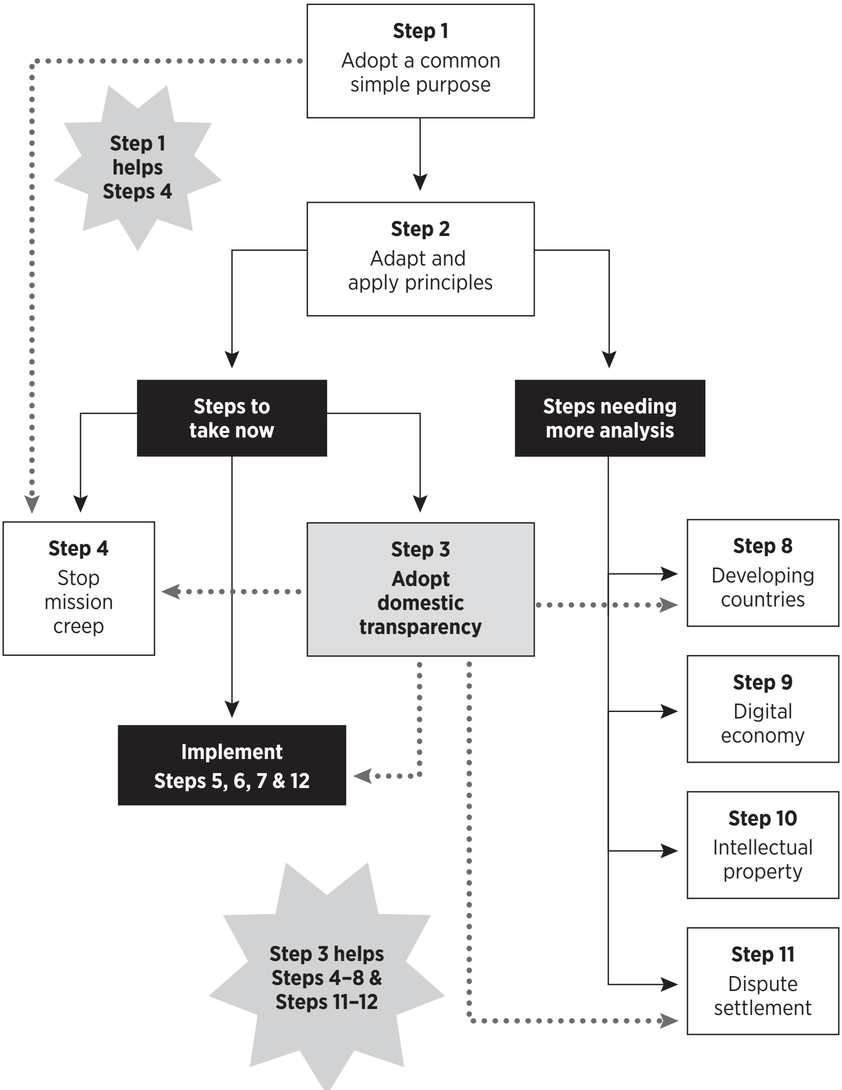
Step 3 also relieves the reliance on Step 11, so it is core.

Step 9: Assess best arrangement for digital economy rules
Step 10: Reassess intellectual property
Step 11: Redesign the dispute settlement system
Step 12: Allow plurilateral agreements only if they are open to all at a later stage

The logic of this 12-step reform process stands. It is unrealistic to suppose that the world in its present state can afford second-best. We cannot afford to reject the chance to make a material improvement to the welfare of our planet.

76 A Stoeckel, D Pearce and G Banks, *Western trade blocs: game, set or match for Asia-Pacific and the world economy?*

Figure 9: Step 3 is core to rebuilding the world trading system



Summary

It is widely recognised that the world trading system is in trouble. There have been calls at recent international meetings for 'root-and-branch' reform of the world trading system. Existing trade rules have 'failed to prevent the spread of protectionism, including unfair subsidies, oligopolistic market structures, overcapacities, and export restrictions'.[77] Three functions of the WTO – negotiating, monitoring trade policies and settling disputes – are either not working or are not working well.

The demise of the WTO system was predictable (and predicted) soon after the failure to launch a round of multilateral trade talks at the meeting of trade ministers in 1999. The Doha Round of trade talks that finally got underway, came to nothing. The rot in the system has been there for some time.

Although the problems in the WTO system are appreciated and recognised, the solutions are not. The lack of remedies is shown by the notable absence of several potential solutions. Steps that stand to make a material improvement to the functioning of the WTO system do not even rate a mention in the discussion about reform. The reason lies in a lack of appreciation of the root causes behind the demise of the multilateral trading system.

To understand why these problems have arisen, and what we need to fix them, we need a better understanding of the basics of international trade.

77 G7 Panel on Economic Resilience, *Key policy recommendations.*

Basics of trade rules

In a world of sovereign nation-states, international trade is the commercial exchange of goods and services across borders. It is extremely valuable. Like the vast bulk of domestic exchange, it is market-driven. Markets are the only proven means of achieving a sustained increase in living standards, and providing the resources needed to deliver the sustainable development goals people desire.

These markets, whether domestic or international, need rules to function efficiently. These rules are diverse. They range from property rights, contract enforcement and payments settlement to standards and regulations that address spillovers. They need constant attention, so they can adapt as things change.

For domestic markets, rules or laws are set by sovereign governments and enforced by a legislature, judiciary and police force. This does not happen in an international context. The 'right' rules, which allow markets to work best, differ across countries because cultures, preferences and circumstances differ. For international exchange, buying and selling in another nation-state's jurisdiction raises the questions of whose rules should apply and how should they be enforced. For international markets to function smoothly and predictably, there are gains from having a set of agreed rules.

There has been compromise in negotiating those agreed rules, and has meant forsaking some sound economic principles that have, over time, eroded the foundations of the WTO system. That leaves us with problem one – a set of old issues to fix.

Problem one: old issues to fix

In a world of nation-states, sovereignty over what happens behind borders means that enforcement of international rules is only possible with voluntary compliance by nations out of their own self-interest.

This leads us to a powerful conclusion. For a rules-based international trading system to work, nation-states must be able to negotiate a set of rules they agree to. For those nation-states to comply with the rules, they must be able to see what is in their own self-interest.

In a democracy, that self-interest test has to be done domestically so that decision-makers who are not acting in the national interest are held accountable. There must be transparency and credibility in the assessments of trade policies. In turn, that means independent assessments of economy-wide social costs and benefits of trade policies, conducted in the national capital.

Autocracies also have to give some regard to the welfare of their citizens, in case they encourage an alternative aspiring leadership to seize power. They too need to consider what is in their own self-interest, even though their accountability mechanism is different from a democracy.

Allowing trade restrictions in retaliation to another country's trade policies is no discipline to a dispute because the case for free trade is overwhelmingly unilateral. It pays to remove your own barriers to trade out of self-interest, regardless of what others do. But the public generally does not see it that way. The predominant view is mercantilist – 'exports are good, imports are bad'. That view is completely wrong: imports are good, they allow people and business access to more things on better terms, lifting their welfare. Exports are good too, but only because they allow the nation to pay for the imports.

The lousy economics behind mercantilism is why reciprocity is now so harmful and should be ditched. Reciprocity has been used because in the past it made good politics. But things have changed. After years of miseducation, lousy economics has led to a lousy political environment where too many people wrongly believe imports are a bad thing.

Arguing for a rules-based system, as the G20 does, is just hollow words if you do not also insist on a domestic transparency institution to assess what is in the national interest. It is the only way the rules will be complied with. A proper domestic transparency process identifies what is in the national interest, it informs and educates the government and the public, it exposes narrow vested interests and weakens their influence, and it helps build coalitions for reform. It leads to a more predictable policy environment, encouraging investment.

In a world of sovereign nation-states, this step is probably the single most important one for achieving a better trading environment. The current Trade Policy Review Mechanism at the WTO does not fulfil these requirements, nor can it ever do so, as it is based in Geneva and not enshrined in domestic capitals.

This WTO's dispute settlement mechanism is currently not functioning. A proper process of domestic transparency of trade policy interventions will reduce the need for a dispute settlement mechanism. When disputes and remedies are accurately assessed, countries that are acting out of self-interest will realise that trade is win–win. It is in their joint interests to negotiate a settlement to any dispute.

The problem with the WTO's dispute settlement mechanism was foreseen by some two decades ago. The system was substantively and politically unsustainable because of the logic of international law and the need for cooperation and consensus. The Appellate Body has become a lawmaker rather than a law interpreter, which is contrary to the basis of international law under a world of sovereign nation-states. The United States have a legitimate point about the problems with the Appellate Body.

In the absence of a domestic transparency institution, which is essential for compliance to international law, the criteria for any proposed dispute mechanism would have to be simple, quick, effective and efficient.

Problem two: mission creep

Respect for the sovereignty of borders means the only tool a country has for influencing trade across their borders is control over the flow of goods and services. This control can be direct, through tariffs, quotas or outright bans, but it can also be indirect, through domestic subsidies, taxes or regulations. All measures can all be converted to a 'tariff or subsidy equivalent'. Tinbergen's principle that, for policy to work, we need as many independent instruments as there are goals implies the WTO system can pursue just one objective.

However, there are multiple goals assigned to the WTO. The agenda suffers from mission creep. Besides the perennial labour and environmental standards, there are a host of new issues covering human rights, climate change, the circular economy, inclusivity and more. Mission creep is common in international agencies, and this is understandable. People don't just want more prosperity, they want cleaner air and water, protection of biodiversity, better human rights – all the things reflected in the UN's Sustainable Development Goals, for starters.

The problem is not the importance or otherwise of these other goals. The issue is whether the WTO system can achieve them with the one independent tool they have. First-best policies may be better managed by another agency or institution that can achieve the desired goal more effectively. Asking the WTO to pursue goals it cannot achieve sets it up for failure and means it will be ultimately discredited by the public.

The WTO system needs to concentrate on core business, where it stands a chance of success. A good place to start is by adopting a simple, clear, outcome-oriented goal. Since trade is simply the commercial exchange of goods and services across borders, that goal is to ensure a set of rules that gives each nation the best opportunity to improve living standards, in a way that is consistent with pursuing their sustainable development goals.

Achieving that goal means adopting a set of principles to apply when agreeing on a set of workable rules. The core principles would be an 'open, non-discriminatory, rules-based, multilateral system where interventions in trade only occur when the national benefits exceed the costs'.

'Open' means the presumption that there are no government-imposed barriers to trade. The only exceptions are where the national benefits from imposing the barrier exceed the costs. This must be assessed by a proper domestic transparency process. If self-sufficiency, national security or some other desired aim of society is challenged by open trade, this will show up in a properly conducted national benefit cost test. This benefit cost test should be extended to *anti-dumping* policies – the 'protectionist's weapon of choice'. *Subsidies* to industry that distort trade should be subject to a proper domestic transparency process. Those that genuinely address market failure, or some other externality, will withstand proper scrutiny.

'Non-discriminatory' means all countries are treated the same and foreign products are treated the same as domestically produced ones. This principle is necessary to ensure competition, which is the discipline that ensures that markets provide best value-for-money goods and services to consumers. Competition also creates the incentive for more innovation and productivity – the basis of improvements in living standards.

Applying the principle of non-discrimination has other implications. First is the contradiction of the *rush to form PTAs*, which, by definition, are discriminatory. Besides the prospect of being welfare-reducing because more trade is diverted than created, PTAs require rules of origin. These are complicated regulations that are costly to navigate. The solution is to systematically multilateralise all PTAs by offering best terms to all WTO members on an MFN basis. The rules of origin problem disappears.

Another discriminatory practice is *preferences for developing countries*. Trade is an important element for development, but preferences erode the non-discrimination principle, which can create perverse incentives and lead to unintended side effects. In many cases, these preferences have ended up being both bad aid and bad trade. The effectiveness of preferences as aid to developing countries needs to be re-examined. The question is whether there is a more effective way for advanced economies to deliver aid to developing countries that would avoid the problems that trade preferences cause for the world trading system.

A 'rules-based' system is important for predictability of commerce across borders and to encourage investment, an aspect rarely measured as a gain to open trade. Just as rare is an appreciation that, for international rules to work in a voluntary system, self-interest is the means. This assessment of national benefits and costs is rarely made in a way that leads to good welfare-enhancing decisions being made.

Problem three: new issues arise

A third set of problems behind the demise of the WTO lies in its inability to address new areas due to its slowness to negotiate issues. The most obvious new area is the explosion of the digital economy, which now touches virtually all aspects of commerce and human interaction. New issues have arisen, such as privacy, cybersecurity and e-commerce standards for international exchange. The enormous economies of scale in the digital world has led to dominance by a few large players. Cultural differences across nation-states have led to different approaches to issues like data privacy.

Despite extensive work by organisations like the OECD, it is not clear how to resolve these issues. There is no substitute for more analysis in this area and this should be a priority, given the accelerated digital uptake during the COVID-19 pandemic.

Another area of trade policy that warrants a rethink is the intellectual property arrangements under the 1995 TRIPS agreement. There is a fundamental conundrum here. New ideas are non-rival, so their marginal cost is zero, and ideas should be freely distributed for the fastest uptake and human progress. But there has to be an incentive to produce the new idea in the first place. What is not produced cannot be consumed. The current solution to this conundrum is to grant temporary monopoly rights through patents, copyright and trademarks to the inventor to create an incentive to produce new ideas. Is this balance right?

Intellectual property rights also feature in many PTAs and regional agreements. How do these align in a multilateral world? The digital revolution also impacts on this, as ideas can now be copied and transmitted more easily.

Problem four: lack of hegemon

A fourth problem facing the WTO system is the decline of multilateralism and lack of a hegemon to provide the leadership to revitalise the system. Multilateralism is efficient, fair and encourages competition, which is the discipline in a market-oriented economy that results in the most innovation and benefit to consumers. Hegemony, if well directed, can speed the process of global agreement and cooperation that is needed in a world of nation-states.

The decline of multilateralism is partly due to mission creep, partly due to the rush into PTAs and partly due to the decline in leadership from the United States. Multilateralism is strongest when the world unites around a single clear purpose, and weakest when multiple agendas are pursued. Adopting a clear outcome-oriented purpose for the WTO system, along with a set of coherent principles, is a good start. Putting all PTAs on an MFN basis is another positive step.

The United States acted as a global hegemon for most of the post-WWII period, particularly on trade. This leadership role has declined, partly due to the economic growth in developing countries and partly because of political choice. The multilateral trading system came under new threat during President Trump's administration.

Hegemony has several elements: power, dominance and projecting good ideas. It is in the leadership of ideas that the United States stands to influence the WTO system for the better, if it chooses to. Dominance can be re-established by forming coalitions of like-minded countries, so plurilateral agreements should be allowed, provided they are on an open basis.

Solutions

There are 12 steps that will make the WTO system function in a better way for the benefit of the world:

Step 1: Adopt a common simple purpose for the WTO system
Step 2: Adopt and apply a set of principles to achieve the WTO's objective
Step 3: Establish a domestic transparency institution in each domestic capital to assess national self-interest from trade policies
Step 4: Stop mission creep
Step 5: Multilateralise all preferential trade agreements
Step 6: Only permit subsidies that address market failures and externalities
Step 7: Assess anti-dumping on both a cost and benefit basis
Step 8: Reassess differential treatment for developing countries
Step 9: Assess best arrangement for digital economy rules
Step 10: Reassess intellectual property
Step 11: Redesign the dispute settlement system
Step 12: Allow plurilateral agreements only if they are open to all at a later stage

The steps are interrelated. The first two are obvious but step 3 is 'core'. Step 3 is essential for the rules to work, and helps achieve steps 4, 5, 6, 7 and 11. Undertaking these 12 steps would make a material difference to the world trading system. Putting them into place would allow good domestic policy to pave the way to good trade policy. Some of those steps will be labelled unrealistic, which is why these problems haven't been fixed. But it is unrealistic to suppose that the world in its present state can afford second-best. We cannot afford to reject the chance to make a material improvement to the welfare of our planet.

APPENDIX

Principles of domestic transparency

In 2008, my colleague Hayden Fisher and I conducted a comparative study on transparency institutions for some key countries. This study aimed to better understand the features that made transparency as a process a success, or not, in leading to better policies.[78]

This appendix, amended where necessary, largely reproduces part of that study that described the elements for success. The key finding was that several elements need to work well for domestic transparency to work.

The best example was Australia's Productivity Commission. The worst was the WTO's trade policy review mechanism. It is important to note that what has worked in Australia is not necessarily translatable to other countries. However, the core features of what makes for success in transparency institutions still stands. These are outlined below.

Open information

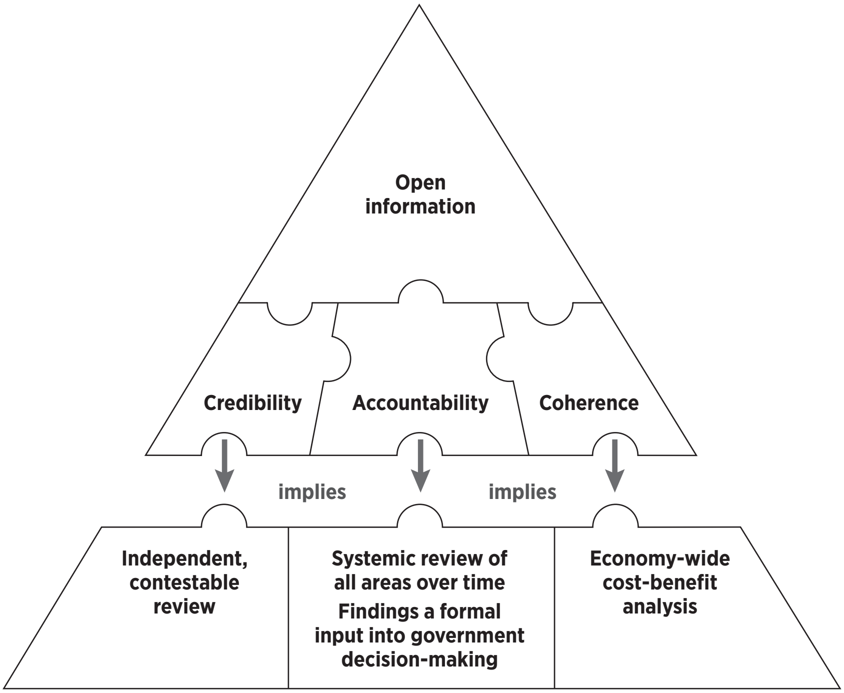
Open information is essential. It sits on top of three interrelated core principles behind good transparent policy development:

- credibility
- accountability
- coherence.

These four core principles require other processes to be present. These elements are shown in Figure 10.

78 Stoeckel and Fisher, *Policy transparency*.

Figure 10: Transparency comprises several inter-related elements



Source: Centre for International Economics

Credibility

Credible, believable findings from policy evaluation are important because the electorate will not vote for governments that do not reflect their wishes. While policymakers need to understand the difference between good policy and bad, ultimately it is voters who have to appreciate and believe in the right policy course. However, appraising policy takes time, effort and some expertise. It is not feasible or efficient for every voter to evaluate each policy issue. Rather, they rely on others whom they trust – media commentators, friends, organisations, academics or others to form a shorthand view of good policy. Sometimes there are formal government reviews of policies, but these reviews will not be believed or accepted if they are not perceived as being independent of government.

Many would argue that 'independence' should be one of the core principles of transparency. But what matters more is that good analysis of the costs and benefits of policy is conducted, and that the public believes the findings. The results of the analysis, and the data and methodology behind it, must be fully transparent so they could be repeated by a third party. In other words, the results of an evaluation need to be contestable, and the quality of the original work should stand on its merits. In this context, 'independence' need not be the prime criterion for acceptance of the findings by the electorate. Repeatability and contestability is, after all, a key principle behind the 'scientific method' by which quality scientific research is conducted.

Credibility is also established by the professionalism and competence of the reviewers. Their reputation will be won by getting it right over time. To put it another way, 'independence' combined with incompetence, or a mandate that defines how the review is to be done, will not be effective. Independent bad work will still be bad work.

A problem with the notion that independence and contestability are somewhat substitutable is that, in reality, repeated appraisals of complex policy will not occur. Resources and expertise are limited, and the cost of repeating work can be high. While contestability relies on the opportunity to repeat and challenge results, the cost can be high enough that findings are never actually challenged. Also, in policy reviews, there is always a need for judgement and experience. The average person may not have the ability to critically evaluate the analysis.

However, although independence is not as important conceptually as the other core principles, on a practical level, the independence of the reviewing agency will be critical for credible findings that are believed and accepted by the public.

Accountability

Accountability is a core component of transparency because it leads to better policy choices and therefore better outcomes by electors, who will choose better governments.

Accountability implies two things. The first aspect of accountability is that the findings of policy reviews must be a formal input into government decision-making. It is government that sets policy, so the costs and benefits of policy reviews, if they are to be effective, need to be used as a formal input into government decision-making. That does not mean government should ignore the politics of a particular policy change. On the contrary, governments are there because of political forces and they cannot ignore them if they want to stay in power. But good economics is also good politics, since 'more' is always preferable to 'less', whether it is income or clean air. Governments are likely to make better welfare-enhancing decisions if they have access to the best economic analysis of policies and when that analysis is widely appreciated by the public. Good analysis also makes it clear what governments, and therefore society, may be giving up if they make decisions on political grounds and ignore the results of economic analysis. Governments are then held more accountable for their decisions and better government should be the result. Not requiring governments to formally consider the findings of independent policy reviews makes it too easy for them to ignore the findings of reviews and give in to narrow vested interests.

The second aspect of accountability is the need for all policy areas of an economy to be systematically reviewed over time, so the electorate can see the performance of the government over a range of decisions. The systematic and repeated review of all policy areas of an economy helps identify policy failings and improves accountability. The systematic review of all areas also helps the fourth core area – policy coherence.

Coherence

The coherence of policies in the national interest is important because piecemeal policies can conflict with policy in other areas of the economy. For example, subsidies to encourage domestic agricultural production and exports run counter to policies that protect manufacturing sectors from import competition, as it is well established that import taxes (tariffs) are a tax on exports. One arm of policy is countering another, so neither has its desired effect.

Policies must be appraised in a way that considers all the economic repercussions. For example, it is not beneficial to focus only on trade policy if tax policy and competition policy are poor and not subject to scrutiny and improvement over time.

Coherence can only be established by reviewing all policies in an economy-wide setting and considering all the linkages throughout the economy. This process is necessary to measure what is in the national interest.

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