

Unit 4: The WTO

Introduction

While the theory of comparative advantage suggests that any two countries acting in their own interests would naturally engage in trade, it isn't always that easy. Historically speaking, keeping lines of trade open has been relatively difficult, since such trade often threatens entrenched political powers or can be used by them to enhance their own power. The current World Trade Organization standoff over developed country agricultural subsidies is a case in point: these subsidies are certainly politically "necessary" in the US and Europe. But they keep more cost efficient producers in developing nations out of the market, and thus in poverty. This section takes a look at the kinds of institutions that are needed for trade to go on smoothly, and how they work. Here, we will highlight the contemporary importance of the World Trade Organization.

Part 1: The Theory of International Organizations as Public Goods

International institutions come in many sizes, shapes and functions. They can:

- promote the interests of countries that produce a particular commodity (OPEC, International Sugar Organization)
- provide regional development finance (Asian Development Bank, North American Development Bank)
- oversee regional trade agreements (Asia-Pacific Economic Cooperation, NAFTA)
- promote international health (World Health Organization, International Red Cross)
- promote global markets and macro-economic stability (IMF, World Trade Organization)

The economic theory that underlies the need for all of these organizations is based on the “public goods” nature of most international agreements. Technically, a public good is defined as any good—or outcome of an international agreement—which is **non-excludable, and non-rival**. Non-excludability refers to the fact that a market’s allocation mechanism, price, cannot regulate access; i.e., is access to the roads in your neighborhood relegated only to those who paid for them? Non-rivalry implies that consumption of a public good by one person does *not* diminish its availability for another; for example, does your neighbor’s use of the roads in your neighborhood diminish your ability to use them? Obviously, the answer in both cases is “no.”

In theory, however, there are few truly public goods: even roads could be excludable (i.e. toll roads), and, at some point, roads do become rival (i.e. traffic jams). A cleaner example of a public good is a public fireworks show on the 4th of July. Price cannot regulate access, since it can presumably be seen by anyone in a certain geographical radius of the show. And one person’s consumption of the show doesn’t limit another’s.

With traditional market forces (e.g., prices) an inadequate supply of public goods is produced. Imagine, for example, the outcome of a private market 4th of July fireworks show—it would probably be less than what everyone was hoping to see. Why? Because even though everyone might want to see a great fireworks show, not everyone will purchase tickets; some will try to free ride. In other words, when other people pay, free riders can get some of it without paying—because access can’t be regulated. This leads to inefficient underproduction, since the usual signal of demand—price—only captures part of the actual demand: the other part of the demand is hidden by those who are “free riders.” And if there are too many free riders, the entire market will ultimately collapse.

In a democracy the decisions of public institutions, which supply the public goods, are a reflection of the majority vote of its private citizens. Public institutions solve the “free riding” problem by using taxes or other fees to produce goods that private citizens on their own might not produce. For example, the NC Department of Transportation, a public institution, receives state income tax revenues to maintain and expand the roads and highways of North Carolina. And the department of parks and recreation in your

town might use local taxes to put on a great fireworks show because the majority of the town “votes” that some of their tax dollars be spent in this way.

The WTO, an international public institution, has responsibility for keeping trade free and fair (and we use the terms somewhat loosely—more about that in a bit) because, as you will see in the exercise in the next section, while *individual* actors might not always opt for free trade (as you might not opt to pay for roads in another neighborhood, or have a 4th of July fireworks show in your town), *it is in the general welfare to keep international markets open*, which we’ve explored in previous units. When a nation restricts imports, it is “free riding” on the international trade system; it expects the “costs” of free trade (loss of jobs in some sectors, lower prices on exports) to be paid by others, while it enjoys its benefits: open markets and a stable international payments system. The WTO is there to prevent this, or an escalation into a full-blown tariff war, from happening.

The WTO is one of many international institutions that serve to regulate the global economy and ensure that international public goods, such as free trade, are provided in adequate supply. The table below summarizes four important public goods provided by international institutions. The WTO is responsible for the first good. The others we cover in later units.

TABLE 2.4 Four Examples of International Public Goods

<i>Public Good</i>	<i>Purpose</i>
1. Open markets in a recession	To prevent a fall in exports from magnifying the effects of a recession.
2. Capital flows to less-developed countries (LDCs)	To assist economic development in poor countries.
3. International money—for settlement of international debts	To maintain a globally accepted system for paying debts.
4. Last resort lending	To prevent the spread of some types of financial crises.

VIDEO: Public Goods

Part 2: Free Rider Exercise: Trade Interdependency

The goal of this exercise is to illustrate the problem of free-riding and show the necessity of an institutional framework in order to prevent such. You will participate in a number of decision rounds where you must decide whether to be a “free trader” or a “protectionist.” You will earn a grade for the exercise based on the average rate of economic (GDP) growth you achieve across the decision rounds. Higher growth rates will be associated with higher grades.

The Payoff Matrix

Majority Decision

	Protectionism	Free Trade
Protectionism	6% GDP growth	10% GDP growth

Your Decision

Free Trade	4% GDP growth	8% GDP growth
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DIRECTIONS. This game includes two sections, each composed of a number of rounds. In each round, you will decide whether you want to choose protectionism or free trade. After each person has voted, you will see the voting results. Your score (i.e., your nation’s GDP) will be determined by how you voted in comparison with the majority of the class. See examples below.

Example #1: You choose protectionism and the majority (>50%) of the class chooses protectionism. Your nation’s GDP grows by 6%.

Example #2: You choose protectionism and the majority (>50%) of the class chooses free trade. Your nation’s GDP grows by 10%.

Example #3: You choose free trade and the majority (>50%) of the class chooses protectionism. Your nation’s GDP grows by 4%.

Example #4: You choose free trade and the majority (>50%) of the class chooses free trade. Your nation’s GDP grows 8%.

In the first section, you will work and vote independently. In the second, you will be able to confer with others before making your vote. In both cases, you should check the results of each round before deciding how to vote in the next round.

Section #1: In this section you will work and vote independently. You will not discuss your choices with other members of the class.

Section #2: You will be given free reign to work together and discuss your choices before starting the first round. You will make further choices based on the majority results. You will also allowed to define the rules that will affect your grades.

For each section you will earn a grade (#/10 points) based on the average GDP growth rate you maintain over the rounds. For example, if section #1 one lasts three rounds and you earned growth rates of 4, 6, and 10, then your grade would be $20/3 = 6.66$ points out of a possible 10. The points you earn during the two sections as well as your participation in the discussions will be used to determine you overall grade for this exercise/discussion.

At the end of the game, we will discuss the results, in particular how “free-riding” affects free trade and protectionism.

VIDEO: Interdependency—Beautiful Mind’s Nash equilibrium and prisoner’s dilemma.

Part 3: From GATT to the WTO: A Brief History

GATT

The WTO officially came into being in 1994, the successor to GATT—the General Agreement on Tariffs and Trade, itself agreed to in 1947. GATT took the place of what was supposed to be the third Bretton Woods institution (along with the IMF and World Bank). However, opposition, particularly from the US, prevented formation of an international body governing trade right after World War II. The GATT was a kind of stopgap measure, made to put something in place: it was not the result of a treaty; its framers never intended it to last for very long. Nonetheless, it grew into an institution fairly capable of securing free trade—especially, its critics say, on rich nations’ behalf.

GATT’s ideals reflected those in the Reciprocal Trade Agreements Act of 1934, which worked powerfully to liberalize trade and simplify the process of making trade policy against the backdrop of Smoot Hawley and the Great Depression. Transparency and non-discrimination were the GATT’s early watchwords: it sought to make international trade subject to clear rules and to ensure that parties were treated equally.

Like the WTO, GATT operated through trade negotiation rounds. Each round had an agenda, and many a list of accomplishments. In its founding Geneva round of 1947, GATT cut tariffs on some 45,000 items among its 23 members. In the next 4 rounds, between ’47 and ’61, it had smaller accomplishments, as Europe sought trade protection in rebuilding. In the Kennedy round of ’64–’67, the GATT enlarged its membership, lowered tariffs overall by 35%, and established codes for different aspects of trade policy, like subsidies, import licensing, meat and dairy product standards, and so on. The Tokyo round (’73–’79) saw increasing fragmentation, due in part to GATT’s growing membership; many nations chose to participate in GATT “à la carte.” They agreed to some core principles set down by GATT, but only adhered to some codes and chose to opt out of others. At this point, GATT also began to deal seriously with non-tariff barriers, with which the WTO is still preoccupied today.

The WTO

The Uruguay round (’86–’93) officially established the WTO, which now addresses new trade issues, such as trade in services (GATS), intellectual property rights (TRIPS) and investment measures (TRIMS). Its dispute settlement mechanism has now been made more effective. Importantly, it is now more than an agreement between “contracting parties” with rules that can be ignored. It is now an agreement that demands adherence to all of its parts.

WEBLINKS/VIDEOS: For more information about the WTO trade issues, click on the links below.

GATS

http://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm

TRIPS

http://www.wto.org/english/tratop_e/trips_e/intel2_e.htm

TRIMS

http://www.wto.org/english/tratop_e/invest_e/trims

Dispute settlement mechanism

http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm

Structural composition of the WTO

http://www.wto.org/english/thewto_e/whatis_e/tif_e/org2_e.htm

VIDEO: History of the transition from GATT to the WTO, a video produced by the WTO

[GATT to the WTO](#) (ID: student, Password: eco300), or available at http://www.wto.org/english/res_e/webcas_e/webcas_e.htm

VIDEO: WTO's dispute resolution process watch

[WTO disputes video](#) (ID: student, Password: eco300), or available at http://www.wto.org/english/res_e/webcas_e/webcas_e.htm

More recent developments at the WTO

Since the Uruguay round, the WTO has stumbled. The Seattle millennium round in '99 was disrupted by street protests and riots, which highlighted the unevenness of international free trade's effects. The protesters, most of whom were peaceful, were comprised of an unlikely assortment of allies: environmentalists, labor unions, human rights activists, liberal clergy, and students against sweatshops were among those who shut down the WTO that weekend. Since then, the Doha round ('02—present) has been plagued with concerns about security, and also with making the WTO seem open to the criticisms aired in Seattle. The most recent talks, in Cancun, Mexico, ran aground over agricultural subsidies in developed regions of the world.

AUDIO: For more on this case listen to:

World trade talks fall apart

<http://www.npr.org/features/feature.php?wflid=1431273>

Regardless of the difficulties the WTO has had in promoting new rounds of trade negotiations, their work continues. Numerous rulings, many of which we've learned about in previous units, have been made; and the outcome of these decisions clearly influence both the economic and political decisions of the member nations—typically in favor of freer trade. An additional example of these rulings is the WTO's 2004 ruling on alleged protectionist practices by the United States against Canadian lumber interests.

WEBLINK/AUDIO CLIP. For an audio clip on the WTO's 2004 ruling on the US-Canadian lumber dispute listen to:

Econ/Unit 4 PDF_WTO
Tuesday, August 17, 2004

BBC audio clip (ID: student, Password: eco370)

Part 4: Arguments in Favor of the WTO

The arguments for the WTO are easy to make, since they are essentially arguments for free trade. In terms of economic theory, it's a no-brainer: the WTO is good because it stands for free trade, and free trade is good because it enhances overall long-run productivity and social welfare.

This argument has any number of dimensions, familiar to the reader by now. Free trade will make the world more prosperous and therefore safer. It will discourage prejudice. It will promote civilization and help the environment. It will raise incomes in poor countries and promote good government in corrupt ones.

As you peruse the links below, you will encounter arguments that we have already covered at some length in favor of trade. Here, such arguments defend the WTO. You will also encounter ethical arguments and appeals to fairness. To what degree do such arguments address the actually existing WTO? To what degree do they address theoretical, rather than achieved, benefits of free trade?

WEBLINKS:

World Trade Organization, "The Case for Open Trade"

http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact3_e.htm

World Trade Organization, "Ten Benefits of the WTO"

http://www.wto.org/english/thewto_e/whatis_e/10ben_e/10b00_e.htm

Renato Ruggiero, "From Vision to Reality: The Multilateral Trading System at Fifty"

http://www.wto.org/english/news_e/sprr_e/wash_e.htm

Supachai Panitchpakdi, "American Leadership and the World Trade Organization: What is the Alternative??"

http://www.wto.org/english/news_e/spsp_e/spsp22_e.htm

Fred L. Smith, "Free Trade for All"

<http://www.cei.org/gencon/005.01318.cfm>

Part 5: Those Who Argue Against the WTO

There are plenty of criticisms of the WTO. Some of them are critiques of the theory of free trade for which the WTO stands, and some are critiques of the way the WTO actually works. In general, critics of the free trade argument suggest that the theory of free trade is all wrong: in order for free trade theory to work, they say, all economies must be at full employment, and the price mechanism must work perfectly and instantaneously to adjust supply to demand. In the absence of those conditions—and those conditions are indeed typically absent—the positive outcomes associated with free trade theory simply do not hold.

Most criticisms of the WTO, however, are more specific. They relate to the way it deals with particular issues: animals, the environment, developing countries, poverty, corporate power, political representation. Moreover, they dispute whether the WTO actually operates and makes decisions by its governing rules. They argue, for example, that although the WTO says that any country can refuse to trade in any good if its production threatens animal species or the environment, or if it is produced with labor conditions objectionable to a country in question, the way the WTO actually operates makes such arguments impossible to sustain in a real dispute.

You might find that such criticisms are the mirror image of those in favor of the WTO. Whereas the latter are a theory in search of facts to support it, the former seem more like facts in search of a theory of economic processes. The question, then, is how can the WTO be reformed? Or should it be? Should it just be tossed out?

WEBLINKS: Explore these weblinks for criticisms of the WTO.

Ten Criticisms of the WTO and (the WTO's Rebuttal)

http://www.wto.org/english/thewto_e/whatis_e/10mis_e/10m00_e.htm

Greenpeace, "Why is the WTO a Problem?"

http://www.greenpeace.org/international_en/campaigns/intro?campaign_id=4003

Animal Rights Activists: Humane Society of the United States, "The WTO"

<http://www.hsus.org/ace/11657>

AFL-CIO, "What is the WTO?"

<http://www.aflcio.org/issuespolitics/globaleconomy/whatis.cfm>

Public Citizen Global Trade Watch, "The WTO"

<http://www.citizen.org/trade/wto/>

Weblinks

During your reading of UNIT 4, Parts 1–3, the following weblinks were presented. Read them now if you have not already done so.

[GATS](#)

[TRIPS](#)

[TRIMS](#)

[dispute settlement mechanism](#)

[structural composition of the WTO](#)

[GATT to the WTO](http://www.wto.org/english/res_e/webcas_e/webcas_e.htm)

[WTO disputes video](http://www.wto.org/english/res_e/webcas_e/webcas_e.htm)

[World trade talks fall apart: NPR audio](#)

[BBC audio clip \(ID: student, Password: eco370\)](#)

[“The Case for Open Trade”](#)

[“Ten benefits of the WTO”](#)

[From Vision to Reality: The Multilateral Trading System at Fifty](#)

[American Leadership and the World Trade Organization:
What is the Alternative??](#)

[Free Trade for All](#)

[Ten criticisms of the WTO](#)

[Why is the WTO a Problem](#)

[Humane Society of the United States](#)

[What is the WTO](#)

<http://www.citizen.org/trade/wto/>