The Economics of GATT:

Making Economic Sense
out of a
'Mercantilist' Institution

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I. Introduction

If the world trading system has a constitution, it is embodied in the Articles of the General Agreement on Tariffs and Trade (GATT) and now its successor organization, the World Trade Organization (WTO). Yet despite the potential importance of GATT rules and principles for shaping the commercial relations of countries, economists have only recently begun to formally and systematically explore how these rules may be understood, what problems they may exist to solve, and how governments may behave in their presence.

Now more than ever, an understanding of what GATT does and how it works is essential. The forces of globalization are strong, and the WTO is facing tremendous pressure to be "accountable" for all that globalization means. But the WTO is not synonymous with globalization, and it is therefore important to characterize the proper role of the WTO in the process of globalization. Legal scholars have, since the pioneering study of John Jackson (1969), spent increasing effort exploring the logic of GATT from the perspective of international law, and many economists have offered informal analyses of various features of GATT. But until recently, economists have not attempted to subject GATT/WTO principles to systematic and formal economic scrutiny. In this paper, I report on some of this recent work.

Specifically, in what follows I argue that the central features of the GATT/WTO can be understood as serving to help governments escape from a terms-of-trade driven Prisoners' Dilemma. In making this argument, I rely heavily on a number of papers that I have written with Kyle Bagwell. In particular, I will present in an informal way some of the arguments established formally in Bagwell and Staiger (1999, 2000, and forthcoming).

I begin in the next section with a brief review of the history of GATT and a minimalist description of its essential features. In section III I then consider how economics can make sense of these features. In section IV I illustrate the application of this perspective by examining the question of how the WTO should approach the controversial issue of labor and environmental standards. Finally, section V offers a brief conclusion.

II. A Brief History of GATT

GATT's design reflects the lessons learned by governments as a result of the trade policy choices they made in the 1920's and 1930's, a period marked by high and increasingly restrictive trade barriers. These barriers reached extreme levels with the enactment in the United States of the Smoot-Hawley Tariff Act of 1930 and the associated retaliatory responses of U.S. trading partners. According to Hudec (1990, p. 5), "the postwar design for international trade policy was animated by a single-minded concern to avoid repeating the disastrous errors of the 1920's and 1930's."

In fact, there were many multilateral attempts during this period to reverse the rising tide of protection. Numerous international conferences were convened between World War I and World War II in an effort to orchestrate a return to the liberal trade policies of the pre-war period. These attempts consisted largely of expressions of support for liberal trading ideals, and invariably they ended in failure (Hudec, 1990, pp. 3-45). The problem was described by a League of Nations report

in this way:

"...trade was consistently regarded as a form of warfare, as a vast game of beggar-my-neighbour, rather than as a co-operative activity from the extension of which all stood to benefit. The latter was the premise on which the post-war conferences based their recommendations – a premise accepted by all in theory but repudiated by almost all in practice. It was repudiated in practice because, as the issue presented itself on one occasion after another, it seemed only too evident that a Government that did not use its bargaining power would always come off second-best." (League of Nations, 1942, p. 120).

The creation of GATT in 1947 marked a fundamental divergence from these earlier attempts. Rather than emphasizing broad expressions of free-trade ideals and attempting to induce governments to collectively and promptly abide by these ideals, GATT provided instead nothing more – or less – than a standing forum for negotiation. The objectives of the original 23 member-governments in creating GATT were recorded in the GATT Preamble:

"*...Recognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods,...*"

The means by which governments hoped to achieve their objectives were also recorded in the GATT Preamble:

"*...Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce,...*"

What was spawned by the creation of GATT was a more-or-less continuous process of trade negotiations which has now extended over 50 some years.

The WTO, GATT's successor organization, was established by the Marrakesh Declaration of April 15 1994, and has built upon and extended GATT principles to cover a number of important new areas, reflecting the broader objectives of its now 135 member governments. But the essential *means* by which governments hoped to achieve their objectives under GATT has not changed with the creation of the WTO, as reflected in this almost-identical language of the WTO Preamble:

"*...Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations,...*"

The foundation for the success of the GATT/WTO as a negotiating forum was laid with a set of rules, contained in a series of GATT Articles. These rules created an environment where governments could voluntarily negotiate greater levels of market access with their trading partners through the *reciprocal* exchange of *non-discriminatory* tariff concessions. An important feature of this environment was the perception that the balance of market access rights (with regard to the

markets of one's trading partners) and obligations (with regard to one's own markets) so attained by each member-government would be secure. That the central function of the rules of GATT is to provide a forum for the exchange of secure market access commitments is expressed, for example, in a recent GATT panel report:

"...the main value of a tariff concession is that it provides an assurance of better market access through improved price competition. Contracting parties negotiate tariff concessions primarily to obtain that advantage. They must therefore be assumed to base their tariff negotiations on the expectation that the price effect of the tariff concessions will not be systematically offset. If no right of redress were given to them in such a case, they would be reluctant to make tariff concessions and the General Agreement would no longer be useful as a legal framework for incorporating the results of trade negotiations." (as quoted in Petersmann, 1997, p. 168).

Hence, at a basic level, the remarkable record of trade liberalization under the GATT/WTO can be attributed to the success with which GATT rules have created a system of well-defined "property rights" over market access, and thereby made possible negotiations directed toward the mutually advantageous exchange of market access commitments.

III. Making Sense of GATT

Yet to international economists trained in the virtues of free trade, GATT's rules seem to be at worst completely unnecessary, and at best needlessly complicated. According to standard economic arguments, these rules are unnecessary, because the standard case for free trade is a unilateral case. Why, then, would one government be willing to help itself with a tariff reduction only if its trading partners made similar "concessions" in an international negotiation? In short, according to these standard economic arguments, the GATT/WTO should not exist!

And even if governments do need some kind of international agreement to pursue mutually beneficial policies, why couldn't they just agree to pursue free trade? Admittedly, this sounds distressingly like the failed proposals of the inter-war period, but might not free trade at least be stated as a clear and simple goal – however difficult it would be to achieve in practice – in the GATT-WTO preamble? Yet the preambles of both the GATT and the WTO miss this opportunity. Instead, these preambles state only that the GATT/WTO objectives are to be served by securing the *elimination of discriminatory treatment* in international trade and a *substantial reduction of tariffs and other barriers to trade*. And the GATT/WTO rules, rather than stipulating free-trade policies, simply provide a legal framework for incorporating the results of negotiations directed toward the reciprocal and mutually advantageous exchange of market access commitments on a non-discriminatory basis.

For economists unfamiliar with GATT, this last observation bears emphasis: free trade is *not* an explicit GATT/WTO objective. The WTO Home Page puts it this way:

"*The WTO does not tell governments how to conduct their trade policies. Rather, it's a '**member-driven**' organization.*" (WTO Home Page).

And judging by the following entry on the WTO Home Page, it might even be argued that free trade is *explicitly not* a GATT/WTO objective!:

"*The WTO is blindly for free trade at any cost. Not true. It's really a question of what countries are willing to bargain with each other*." (WTO Home Page).

Without free trade to lean upon, how, then, are international economists to make sense of GATT?

A view shared by many economists is that the logic of GATT, if indeed it has any logic at all, is the logic of "enlightened mercantilism." This view is regularly advanced, but a particularly eloquent statement of it is provided by Krugman (1991):

"To make sense of international trade negotiations, one needs to remember three simple rules about the objectives of negotiating countries:

1). Exports are good.
2). Imports are bad.
3). Other things equal, an equal increase in imports and exports is good.

In other words, GATT-think is enlightened mercantilism." (Krugman, p. 25, 1991).

By contrast, below I describe in general terms the view that GATT's essential features can be interpreted and understood with standard economic arguments. According to this view, GATT's rules are best seen as aiding governments in their attempts to escape from a terms-of-trade-driven Prisoners' Dilemma. To illustrate some of the key ideas, I will rely on little more than the standard competitive general equilibrium model of trade taught in the typical undergraduate international economics course.

I begin with a basic question: What can GATT negotiations accomplish for its member governments? It is useful to answer this question in two parts: first, from the perspective of a world in which all countries are truly "small;" and then from the perspective of a world in which countries are large enough to have effects on markets outside of their borders.

GATT in a World of Small Countries

If countries are sufficiently small so that each alone has no effect on the prices in markets outside its borders, then GATT negotiations can't help the governments of these countries get more of what they want. However, GATT negotiations might help these governments get less of what they don't *really* want. The first statement holds under the standard conditions of tariff analysis, and remains valid whether governments are concerned only about real national income or value as well the distributional consequences of their tariff choices. The second statement applies when governments face commitment problems with respect to their own private sectors.

To see the validity of the first statement, it need only be observed that, when countries are small and when governments are capable of making policy commitments to their private sectors, the unilateral trade policy decisions of these governments are *efficient* on a world-wide scale, when viewed from the objectives of each government, and hence there can be no basis for international negotiation. If governments seek to maximize real national income with their tariff choices, this is just the familiar statement that the traditional unilateral "optimal tariff" of a small country is zero

(and also efficient). If governments pursue distributional/political goals with their tariff choices as well, the optimal tariff chosen unilaterally by a small country need not be zero, but it is still efficient. The key point is that, if a country is truly small on world markets, then it faces the "right" incentives when unilaterally choosing its own trade policy, because it enjoys all the benefits and pays all the costs of these choices.

Figure 1 illustrates the basic idea. The top panel of this figure depicts the familiar effects of the imposition of a tariff for a small country who, at free trade, is an importer of good *x* and an exporter of good *y* and achieves a level of real national income associated with the indifference curve labeled W^F. As the bottom panels of the figure indicate, imposing a tariff on its imports of *x* shifts in the country's import demand curve from the curve labeled M_x^F to that labeled M_x^T. But this does not alter the equilibrium "world" price $\tilde{p}^w$ (i.e. the ratio of prices received by domestic firms exporting *x* to prices received by foreign firms exporting *y*), because the country is by assumption small in world markets. Reflecting this fixed world price, the top panel of the figure illustrates the loss in real national income that would be associated with a positive tariff, indicated by the indifference curve labeled W^T. If the government seeks to maximize real national income with its unilateral tariff choice, then as suggested by the top panel of Figure 1 it can do no better than to adopt a policy of free trade, and if all governments pursue analogous objectives then each will adopt a unilateral free trade stance. This, of course, is efficient from a world-wide perspective, and we may then conclude that there is nothing for national-income maximizing governments of small countries to negotiate about.

But the same conclusion applies even if these governments are not simply maximizing real national income with their unilateral tariff choices, but place value as well on the distributional/political effects of their tariff choices, and so adopt unilateral policies that diverge (perhaps significantly) from free trade. For example, in terms of the top panel of Figure 1, a tariff will reduce the real national income available to a small country, but it also redistributes the available national income across the population through the impact on local prices that the tariff implies. A government might value this redistribution, and so be willing to suffer some reduction in real national income in order to achieve it. Nevertheless, the unilateral tariff choices of this government will still be efficient from a world-wide perspective – in light of its own objectives and the objectives of its trading partners – because the fixed world price ensures that the government faces all of the costs and benefits of its choices. Hence, we may conclude that there is nothing for the governments of small countries to negotiate about, regardless of the underlying motivations for their tariff choices.

Even in a world in which all countries are small, however, GATT may have something to offer the governments of these countries, if they face difficulties in making commitments to their private sectors. For example, a government might wish to commit, ex ante, to a policy of free trade, but its incentives to offer protection might change, ex post, once investment and resource allocation decisions had been made by the private sector. If the government is unable to credibly commit to its ex-ante policy choice, then it may find that the private sector expects – and it has reason to deliver – the tariff policy that is optimal for it to choose ex post. In this case, the unilateral tariff choices

of a government, while still efficient from the perspective of its own *ex-post* preferences, may not be efficient when gauged by its *ex-ante* preferences.

When this is the case, governments could have something to gain from GATT negotiations, even if all countries are small, if these governments can utilize their international commitments to solve their commitment problems at home. By so doing, GATT negotiations to lower tariffs could help each government rid itself of protection that it didn't *really* (i.e., in an ex-ante sense) want in the first place. In fact, there is some evidence that GATT commitments do help member-governments make domestic commitments of this form (see Staiger and Tabellini, 1999).

Nevertheless, it seems unlikely that securing domestic commitments against their own private sectors is the *only* explanation for why governments negotiate in GATT, and it is quite possibly not even the central explanation for GATT negotiations, if for no other reason than this explanation goes against the common sense explanation that every trade-policy practitioner knows: governments negotiate trade agreements, not because they wish to reduce their own trade barriers, but because they seek to reduce the trade barriers of their trading partners, and they are willing to "pay" – with market access "concessions" of their own – for the greater access to foreign markets that lower foreign barriers would bring. As it turns out, this common-sense view – as well as a number of the core features of GATT's architecture – can be explained, once we consider a world in which countries are large enough to effect prices in the markets outside their borders.

<u>*GATT in a World of Large Countries*</u>

To illustrate, let us begin by seeing how Krugman's three rules of "GATT-think" can be explained within a large-country setting. A first observation is that there is nothing necessarily "mercantilist" about a government desiring more market access from its trading partners, and viewing access to its own markets as something to be conceded only in exchange for something else of value. The simple point is that, in contrast to the mercantilist idea of setting one's *own* policies to stimulate one's exports, GATT negotiators seek to stimulate their countries' exports by securing changes in the policies of their *trading partners*. And this makes all the difference.

Figure 2A illustrates, with world prices (the terms of trade) now determined so as to equate the excess demands of the (large) home country with the excess supplies of its trading partners. The top panel of this figure depicts the terms-of-trade deterioration that would be suffered by the home government if it pursued a policy of expanding its exports with, say, an increase in the export subsidies it offers its firms. The bottom panel of the figure, by contrast, depicts the terms-of-trade improvement that the home country would enjoy if the home government can convince its trading partners to accept more of its exports (i.e., give it more market access). The top panel can be interpreted as illustrating the folly of pursuing mercantilist policies. The bottom panel simply points to the wisdom (in the case illustrated, for the domestic government) of convincing trading partners to open their markets to one's exports, and the potential cost (in the case illustrated, for the foreign governments) associated with providing access to one's own markets.

From this perspective, Krugman's first two rules of GATT-think are no mystery at all.

According to the standard trade model, trade negotiators *should* view increased exports as a good thing, if these increased exports are the result of market-opening foreign policy changes (a grant of increased foreign market access), because of the terms-of-trade improvements that these foreign policy changes would bring. Similarly, trade negotiators should view increased imports as a bad thing, if these increased imports are the result of market-opening domestic policy changes (a concession of increased domestic market access), because of the terms-of-trade deterioration that these domestic policy changes would bring. The real puzzle is how each government could expect to gain from negotiations if each has objectives of this nature. After all, the terms of trade cannot improve for *every* country! The basis of a resolution to this puzzle is contained in Krugman's third rule of GATT-think, which reflects GATT's concept of *reciprocity*: other things equal, an equal increase in imports and exports is good.

As it turns out, the concept of reciprocity plays an important role in GATT negotiations, but its role is more subtle than a rigid application of Krugman's third rule of GATT-think would indicate. Nevertheless, at a broad level, the key features of reciprocity in trade negotiations can be appreciated, once it is observed that negotiations which conform to reciprocity *fix the world price*. To see this, consider a set of negotiated policy adjustments that bring about changes in the volume of the home-country's imports that are of equal value to changes in the volume of its exports, so that $\tilde{p}^w[M_x^/ - M_x] = [E_y^/ - E_y]$. Applying the balanced trade condition under each set of policies, this condition reduces to $[\tilde{p}^{w/} - \tilde{p}^w]M_x^/ = 0$, and so the equilibrium world price must remain unchanged. In terms of the market for good *x*, Figure 2B illustrates that trade-liberalizing negotiations which conform to reciprocity will, at the original world prices, increase the home-country's demand for imports of *x* by exactly the same amount as the increase in the export supply of x from the home-country's trading partners, leaving the equilibrium terms of trade unchanged.

The upshot is that trade-liberalizing negotiations that conform to reciprocity will leave all countries with more market access but no change in the terms of trade. But why would governments desire this? To see this, we must return to examine the unilateral trade policy decisions of the government of a large country.

The key features of the unilateral trade policy choice made by the government of a large country are illustrated in Figure 3. Let us suppose that the home government has chosen a tariff that is optimal for it, given its objectives. Let us suppose also that, from the government's perspective, this unilateral choice reflects a particular balance: on the margin, the government perceives the benefits of greater redistribution that would come from a further increase in the tariff as just balancing the additional reduction in real national income that the further tariff increase would bring.

Two important distinctions may now be drawn between this case and the analogous decision described above for a small country. First, on the margin, the home government does not face the full cost of its tariff choice, but instead *shifts* some of these costs onto its trading partners. This cost-shifting comes about through the terms-of-trade movement that the government's tariff choices imply. In particular, as the lower panel of Figure 3 illustrates, by denying market access to its trading partners with a slightly higher tariff (shifting its import demand curve in from M_x to $M_x^/$), the home-

government improves its terms of trade, and the real national income costs of the additional protection are thereby reduced for the home country, as the top panel of Figure 3 depicts. Of course, these induced terms-of-trade movements diminish the real national income of the foreign trading partners, and in this way foreign trading partners bear some of the costs of the home-government's decision to protect its import sector.

A first important distinction between the unilateral trade policy decision in the small-country world and the large-country world is now clear. From a world-wide perspective, the domestic government will *over-protect* its import sector when the domestic country is large in world markets, because it does not bear all the costs of this decision. We have thus identified an inefficiency associated with the unilateral tariff choices of the governments of large countries. Moreover, despite a broad range of political/distributional/economic objectives that these governments may pursue with their trade policy choices, this inefficiency stems from a single source: the ability of these governments to shift the costs of their trade policy decisions on to their trading partners through movements in world prices.

Having identified an inefficiency, we may now also draw a second important distinction between this case and that of a world of small countries discussed above. Governments of large countries can benefit from trade-liberalizing tariff negotiations, and each government will *assuredly* benefit from (at least a small amount of) negotiated trade liberalization that conforms to *reciprocity*. This can be seen with reference to Figure 3, by recalling that the unilateral choice made by the home-government balances, on the one hand, the marginal benefits of greater redistribution that would come from a further increase in the tariff, and on the other, the marginal costs in terms of reduced real national income that the further tariff increase would bring. But the latter includes terms-of-trade effects, which reciprocal changes in home and foreign tariffs would neutralize, and when these terms-of-trade effects are neutralized by reciprocity, the home-government perceives a greater marginal cost associated with its existing tariff level, thereby making (reciprocal) liberalization attractive to it. Of course, a similar observation applies to the governments of the foreign trading partners. Hence, according to the standard trade model, trade negotiators *should* view an equal increase in imports and exports as a good thing, just as the third rule of GATT-think indicates they do.

In broad terms, then, I have described how Krugman's three rules of GATT-think can be explained within a large-country setting using the standard model of international trade. Unifying this explanation is the underlying notion that GATT's rules may be interpreted as helping governments escape from a terms-of-trade-driven Prisoners' Dilemma.

Of course, in real-world trade policy negotiations, the abstract notion of a country's terms of trade is rarely if ever mentioned, and so one might be skeptical of the view that the key features of GATT have anything to do with a terms-of-trade driven Prisoners' Dilemma. But few would argue with the view that GATT's rules have everything to do with *market access*. In fact, it is probably not an exaggeration to say that virtually every tariff that has ever been bound in a GATT negotiation has been bound because some exporters in some country place value on the market

access that such a binding implies. Yet when a government raises its import tariff and thereby shifts in its import demand curve, the associated "volume effect" (i.e., the reduction in market access suffered by its trading partners) has a corresponding "price effect" (i.e., the country's terms-of-trade improvement). And if exporters in one country place value on gaining access to the markets of another, it is because those markets are "large," in the sense that the degree of access to them affects the prices received by these exporters (i.e., "world" prices). Consequently, far from being irrelevant to real-world trade policy negotiations, the terms-of-trade perspective provides a rather direct theory of the market-access concerns that dominate these negotiations.

Finally, while I have focused on Krugman's three rules of GATT-think, let me now be more explicit about how GATT's rules can be seen as aiding governments in their attempt to escape from a terms-of-trade driven Prisoners' Dilemma. I mentioned above that the actual role of reciprocity in GATT is more subtle than is reflected in the third rule of GATT-think. But it is still the case that the essential purpose of reciprocity in GATT may be given an interpretation broadly similar to that described above. Namely, the principle of reciprocity in GATT serves as a negotiating rule that can neutralize the cost-shifting incentives that governments would otherwise face when determining their trade policies, and which would otherwise prevent them from making efficient trade policy choices from a world-wide perspective.

By the same token, a second key principle of GATT may be understood from this perspective: the principle of *non-discrimination*. In a multi-country world, the desirable features of reciprocity can be preserved if and only if the principle of reciprocity is joined with the principle of non-discrimination, because when tariffs are discriminatory cost-shifting can occur through local price effects. As a consequence, with discriminatory tariffs it is possible for a government to shift the costs of protection onto its trading partners even when world prices are fixed (which reciprocity accomplishes). By contrast, when tariffs are required to satisfy the principle of non-discrimination, the only mechanism by which cost-shifting can occur is through world-price movements, which the principle of reciprocity is well-equipped to handle.

Hence, in broad terms, GATT's central principles may be understood to serve governments in their attempt to escape from a terms-of-trade-driven Prisoners' Dilemma. The principle of non-discrimination restricts the means by which countries may shift costs onto one another to travel only through world prices, and the principle of reciprocity neutralizes the world-price effects of trade policy changes, thereby eliminating the remaining source of inefficient policy choices in a non-discriminatory world. The other GATT rules may then be viewed as existing largely to preserve and enforce the balance of market access commitments that governments voluntarily negotiate.

IV. What does this have to do with Seattle?

If GATT/WTO rules can be interpreted as helping governments escape from a terms-of-trade driven Prisoners' Dilemma, can this perspective also be used to shed light on current challenges facing the WTO? In this section, I mention one such challenge, and I briefly describe how this perspective may be useful in thinking about the issues involved.

A key challenge currently faced by the WTO concerns the issue of labor and environmental standards. This issue became a prominent and controversial feature of the public debate over "globalization" during and after the WTO ministerial meeting in Seattle, though it has been growing in prominence within GATT and now the WTO for some time. Existing GATT rules speak to this issue only when market access concerns are directly involved, as when one GATT member raises discriminatory tariffs against the exports of a second GATT member in response to the weak labor standards of the second member, or when a GATT member adopts a new environmental standard that has the effect of reducing access to its markets that another GATT member had previously negotiated. Unlike tariffs, the level of national labor and environmental standards has never been the subject of direct GATT negotiations. But there is mounting pressure for this to change under the WTO. A number of industrialized countries (with the United States taking a leading position) have recently advocated the adoption of a "social clause," in which a set of minimum international standards would be negotiated and then enforced with the threat of trade sanctions. The intended target of the floor envisioned by the social clause is, of course, the standards of the developing world.

This controversy raises a number of important challenges for the GATT/WTO, but among these challenges a prominent question is this: Is GATT's traditional preoccupation with market access misplaced when the issue of labor and environmental standards is raised? The perspective outlined above can answer this question with a *qualified* "No." The central qualification is that the "global commons" aspects of labor and environmental issues are separated from the "race-to-the-bottom" concerns associated with these issues, and that the GATT/WTO is assigned to the task of dealing directly only with the latter. There is a logic to this assignment: global commons issues are *not* fundamentally trade issues; the prospect of a race to the bottom *is* fundamentally connected to trade, and hence to the business of the GATT/WTO.

Consider, then, the problem of the race to the bottom. This problem reflects a fear that the continuing process of negotiated international integration could fuel delays in the strengthening – or could even lead to an outright weakening – of a nation's labor and environmental standards, in order for the nation to reap the competitive effects that weaker standards might produce. Now, if a government had a full arsenal of trade policy options at its disposal, it would presumably use these trade policies to produce the desired level of intervention on the part of its firms in international markets, and it would not have to resort to manipulating its labor and environmental standards for this purpose. But if its trade policy options have been constrained by GATT commitments which it had previously negotiated, then weakening its domestic standards may be the most practical way that the government can respond to growing competitive pressures from abroad. This is the way in which a damaging race to the bottom could be fueled by GATT commitments.

But an important observation may now be made: the standards of the developing world are not really the source of the race-to-the-bottom problem. Fundamentally, the possibility of a race to the bottom arises under WTO rules only if the link between a country's tariff commitments and changes in its *own* domestic standards is insufficient to generate secure "property rights" over negotiated levels of *market access*.

Figure 4 illustrates the basic point. Suppose the domestic government and the governments of its foreign trading partners initially negotiate a reciprocal reduction in import tariffs which lead to an outward shift of the domestic import demand curve from M_x to $M_x^{/}$, and to an outward shift of the foreign export supply curve from E_y^* to $E_y^{*/}$. The level of domestic market access that the foreign trading partners can anticipate as a result of these tariff negotiations is denoted by $m_x^{/}$, which is an amount greater than the original level of domestic market access provided to foreign producers prior to the negotiation, denoted by m_x.

With its tariff now bound by a negotiated GATT commitment, the domestic government may be tempted to "recapture" a portion of this market access: by weakening the standards it imposes on its import-competing firms and thereby shifting back the domestic import demand curve, the domestic government can diminish the level of market access it affords its foreign trading partners to the level $m_x^{///}$ in Figure 4. This is the most extreme manifestation of the race-to-the-bottom fear: negotiated international integration leading to an outright weakening of a nation's labor and environmental standards, in order for the nation to reap the competitive effects that weaker standards might produce. Notice, too, that this maneuver by the domestic government triggers a harmful terms-of-trade deterioration for its foreign trading partners. But if the property rights shared by foreign trading partners over the domestic market access levels they had negotiated were secure, so that the domestic government were required – subsequent to negotiations with its foreign trading partners – to match any weakening of its domestic standards with a market-access-stabilizing reduction in its import tariff, then it would be unable to engineer a unilateral inward shift of its import demand curve by weakening its domestic standards. With secure property rights over negotiated market access, then, the motives for weakening domestic standards would be eliminated, and the fuel to the race to the bottom cut off.

Suppose, alternatively, that subsequent to its tariff negotiation the domestic government wished to strengthen the standards it imposes on its import-competing firms. This by itself would shift its import demand curve out to that labeled $M_x^{//}$ in Figure 4 generating an associated level of market access $m_x^{//}$, and so at the previously-negotiated tariff levels the domestic government would be offering greater market access to its foreign trading partners than it had originally negotiated (and presumably desired). If bound to its negotiated tariff, the augmented level of domestic market access (and the associated decline in the domestic terms of trade) implied by the stronger standards might cause the domestic government to delay their implementation. This is a less extreme manifestation of the race-to-the-bottom fear: negotiated international integration leading to a delay in the strengthening of a nation's labor and environmental standards, in order for the nation to reap the competitive effects that weaker standards might produce. But again, if property rights over negotiated levels of market access were secure, and the domestic government were permitted – subsequent to negotiations with its foreign trading partners – to match any strengthening of its domestic standards with a market-access-stabilizing increase in its import tariff, then it would be able to "de-link" its standards choices from their competitive effects. And once again, with secure property rights over negotiated market access, then, the motives for weakening domestic standards would be eliminated, and the fuel to the race to the bottom cut off.

It is not clear whether, in practice, WTO rules provide links between a country's tariff commitments and changes in its own domestic standards that are sufficient to generate secure “property rights” over negotiated levels of market access (though GATT’s so-called non-violation nullification-or-impairment clause would in principle provide such a link). But what the above discussion indicates is that, where race-to-the-bottom concerns associated with labor and environmental standards are prominent, GATT’s traditional preoccupation with market access is exactly on the mark.

V. Conclusion

I have described recent work on the theory of trade agreements that speaks to the design of GATT. I have argued that, in the absence of a trade agreement, the unilateral trade policy choices of the governments of large countries would give rise to inefficiencies that stem from a common source: the ability to shift costs on to trading partners through world price movements. With this “problem” identified, I have then illustrated how GATT’s central features can be interpreted as offering a “solution” to this problem, and thereby as offering governments an avenue of escape from a terms-of-trade driven Prisoners’ Dilemma. Finally, I have illustrated how this perspective can be applied to the study of “new issues” currently before the WTO, by examining how the WTO might approach the issue of labor and environmental standards.

This line of research is still in its infancy. My description of GATT’s key features here has just scratched the surface of the complex reality of GATT/WTO rules. And there are a host of important empirical questions raised by this research that should be addressed. But I hope that by describing this research I have convinced others that the GATT/WTO is an institution whose broad features can be understood with economic principles, and that the study of the GATT/WTO from an economic perspective is a promising area of future research.

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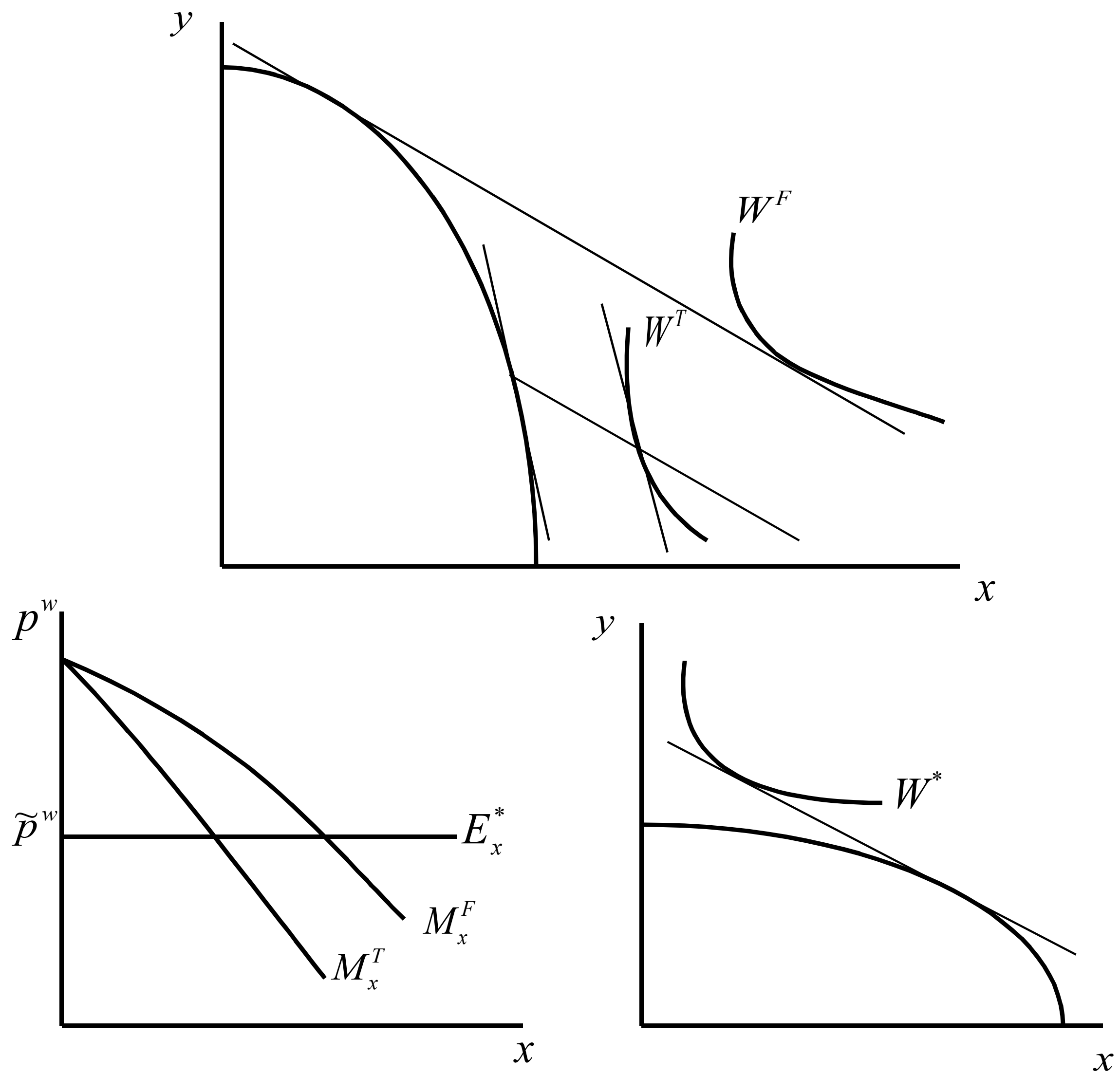
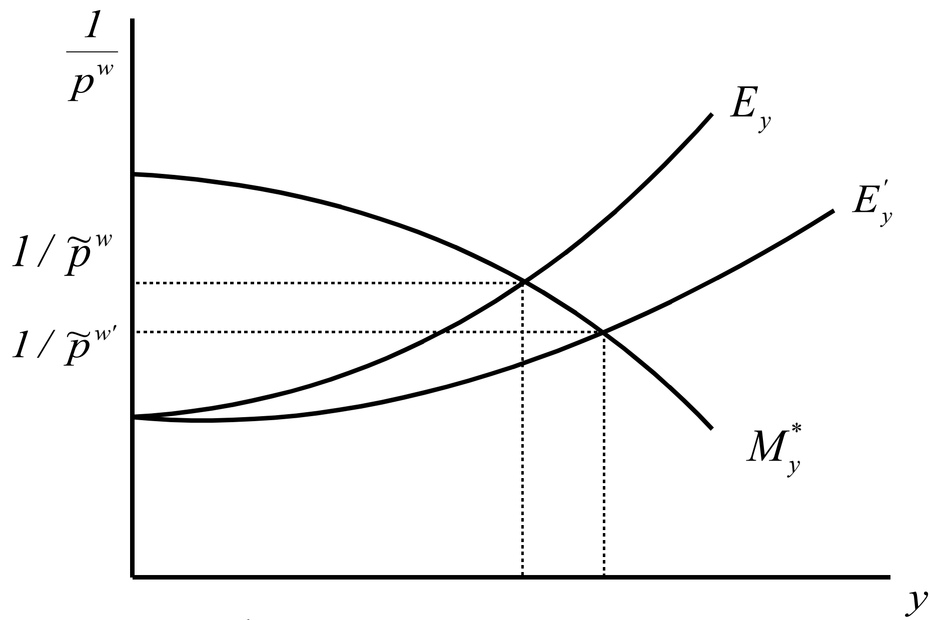


Figure 1



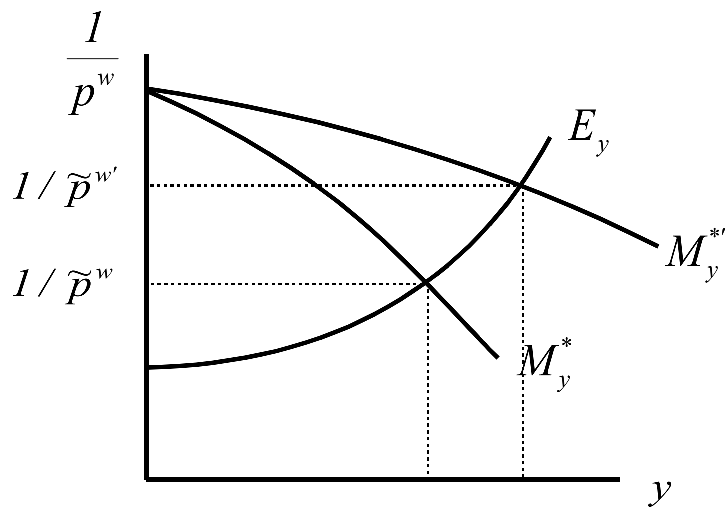


Figure 2A

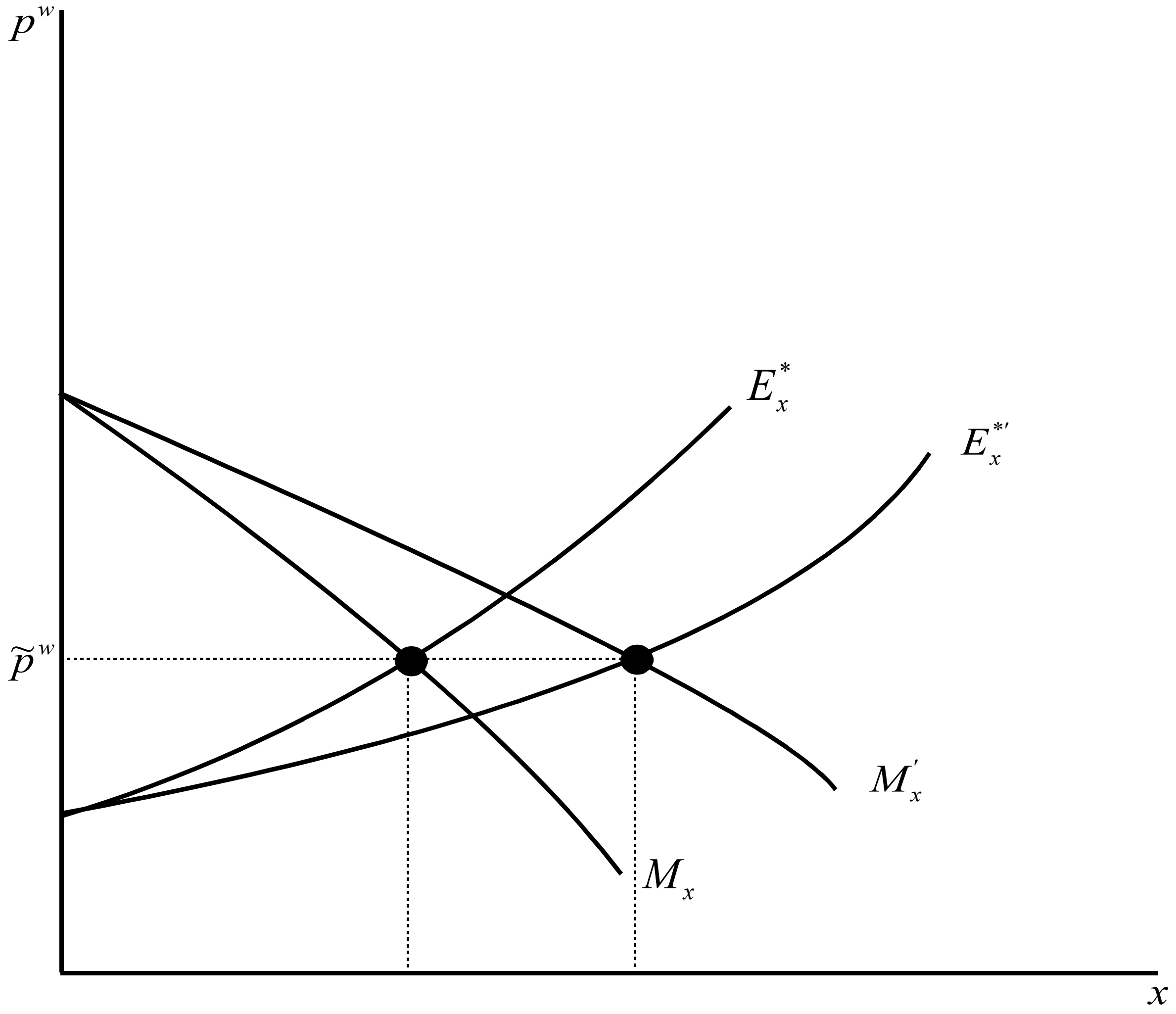
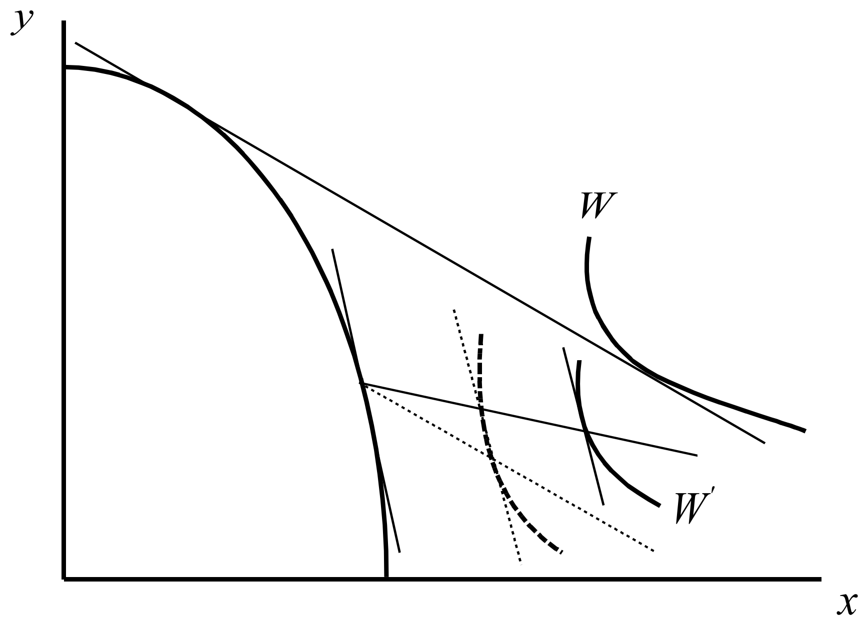


Figure 2B



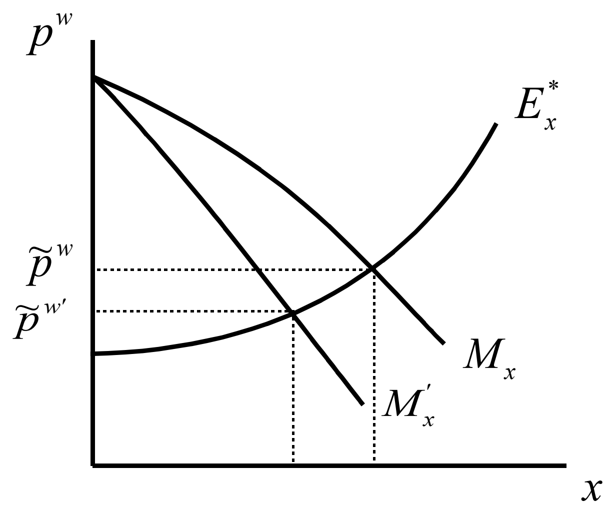


Figure 3

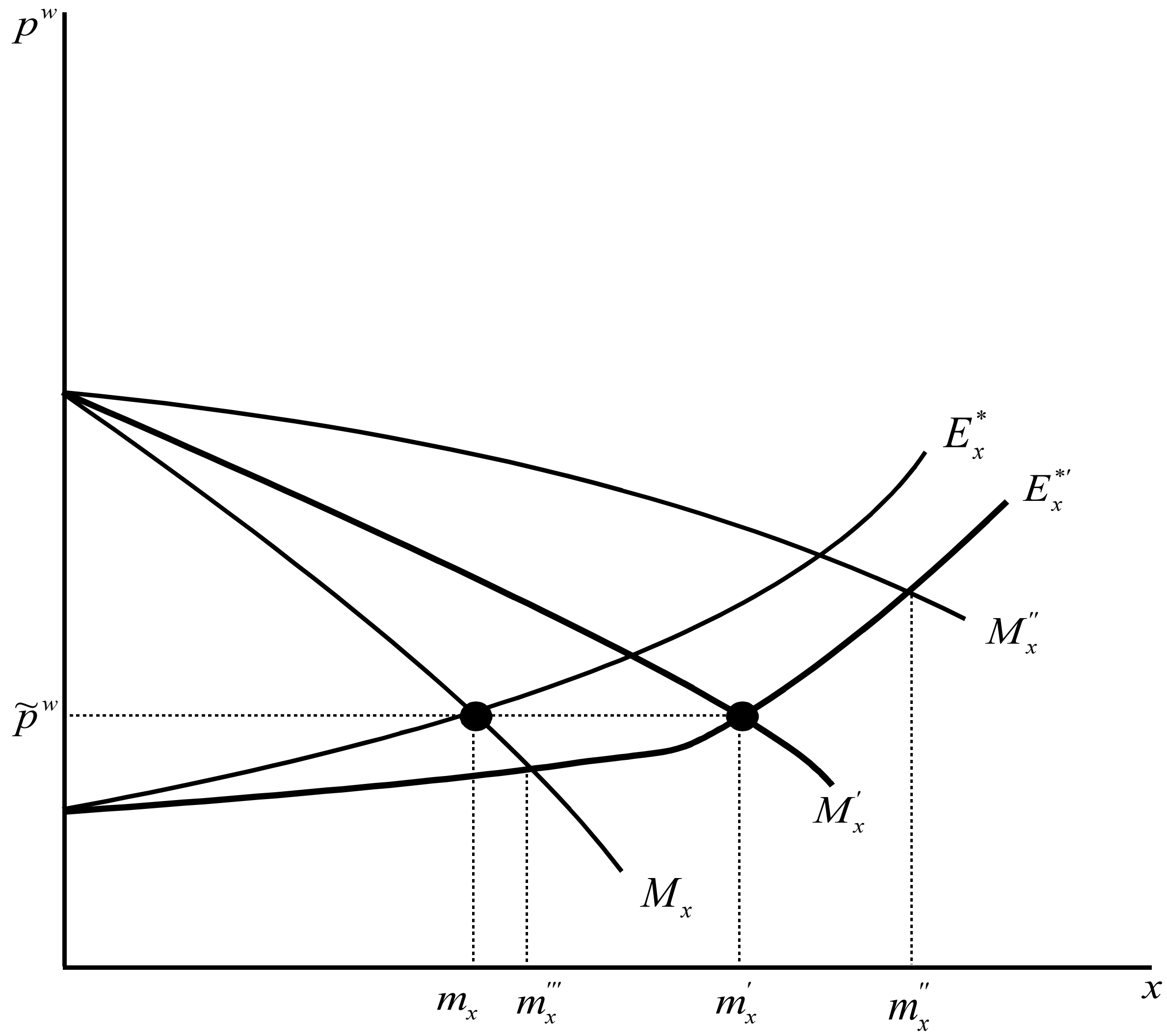


Figure 4