TRADE talks

A podcast about the economics of trade & policy
with Chad P. Bown

Episode 180. The WTO is in trouble.

Econ 101 to the rescue?

Episode webpage

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Transcript

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Chad Bown: The World Trade Organization is really struggling. The last major effort by its member countries to do big, multilateral negotiations – the Doha Round – fell flat. Doha had to be abandoned, without a deal, after more than a decade of talks.

Frustrated, in the early 2010s, major member countries started looking elsewhere. Things like TPP and TTIP and RCEP – big mega-regional deals – were where countries went to negotiate instead of the WTO, to try to tackle the new trade issues that weren't going anywhere in Geneva.

More recently, you have China and worries that its massive non-market economy is just so different, that maybe China just doesn't fit into the rules-based trading system. Maybe the United States needed to push for some other, non-WTO, way of dealing with China.

And then there is climate change. Member countries have failed to engage the WTO on that pivotal global issue.

The WTO really is under threat. To help us think about the future and ways to fix the WTO, I wanted to better understand its past.

This episode explores the economic principles behind the World Trade Organization as well as its predecessor, the GATT, the General Agreement on Tariffs and Trade – i.e., the basic Econ 101 of the WTO. Why we need it, and how it works.

To help us do all that, I will be joined by a very special guest.

Chad Bown: How long have you been an economist?

Bob Staiger: I got my PhD in 1985, so it has been a long, long time.

Chad Bown: That is Bob Staiger. Bob is an economics professor at Dartmouth College. No economist has written more about the WTO over the last 30 years than Bob Staiger. Bob has an incredible new book titled, "A World Trading System for the Twenty-First Century," some of which I have asked for him to share with us today.

Chad Bown: Hi, Bob.

Bob Staiger: Hi, Chad.

Chad Bown: You are listening to an episode of *Trade Talks*, a podcast about the economics of trade and policy. I'm your host, Chad Bown, the Reginald Jones Senior Fellow at the Peterson Institute for International Economics in Washington.

For our listeners – if you make it all the way until the end of this episode, you will hear more about my own personal relationship with Bob Staiger.

PART I. THE ECONOMIC THEORY BEHIND THE WTO (03:08)

Chad Bown: I want to begin by talking about free trade. Let's start with the WTO itself. Does the World Trade Organization indicate anywhere that its objective is to get countries to impose zero tariffs and get them all the way to free trade?

Bob Staiger: The short answer to that question is no. If you look at the WTO website, you'll find a tab that says "What we stand for," and you might expect a statement there. But in fact, that statement never mentions the goal of free trade. It does mention the goal of freer trade but never says free trade is the goal, even aspirationally.

A bit more authoritative source would be to go to the actual legal text of the WTO or the GATT and look at the preamble. The preamble is the legal statement by the member governments of what exactly their objectives are. And in the preamble, there is no mention of free trade as a goal. There is a mention of reducing tariffs, and substantially reducing tariffs, but no mention of free trade.

Chad Bown: So, the WTO doesn't say free trade anywhere. Maybe it's not at all about economics then. Maybe it's all about lawyers or diplomats or military alliances.

Bob Staiger: That's certainly possible, but I think it would be pretty weird if that were true for at least three reasons.

First, the WTO is about the international economic relations between countries. And so, if it did not have some economic principles, that would be quite strange.

Second, if we look at the 75-year history of the GATT, it's been extremely successful in liberalizing trade. And so, if there weren't some economic principles behind it that would be surprising.

And third, a principal architect of the GATT was the economist and future Nobel Laureate, James Meade. So again, the idea that economics is not behind the GATT is something that seems unlikely.

Chad Bown: These are clues that there is likely to be some serious economics behind the GATT and behind the WTO. But the idea that the WTO is not about the economic efficiency case for free trade: Is that a good or a bad thing?

Bob Staiger: So as an economist, I actually think it's a good thing that the WTO, and the GATT before it, is not based on the case for free trade. Because that case, as economists know, is based on a lot of strong assumptions that typically are not going to hold in the real world for many of the member countries of the GATT and the WTO.

Those assumptions include things like governments not wanting to use tariffs for distributional purposes, either because they don't care about the income distribution within their country or because they have better instruments to achieve that. And while some governments may – the US could be a good example, and possibly Europe – many of the WTO member governments, two thirds of which are developing countries, are not going to have these (domestic tax) instruments.

So, the assumptions that are required for the economist case for free trade are really suspect when applied to the WTO membership. And if that were the basis for the WTO's claim of legitimacy as the constitution of the world trading system, I would be suspect of that claim.

Chad Bown: If the economic basis for the WTO is not free trade, then what is it?

Bob Staiger: I think the basis for the WTO in terms of economics is something far more general than the case for free trade. And that is the case for countries to internalize the externalities that they impose on each other when they choose their trade policies. And by externalities, what I mean is the effects that are imposed on other countries when a country unilaterally makes tariff choices.

When a country takes account of the international externalities that it's imposing on its trading partners through its tariff choices, that's going to naturally lead the country to adopt lower tariffs, but there's no necessary reason why those tariffs should be driven all the way to zero.

Chad Bown: The economic case for the WTO requires imagining a world without it. Without a WTO, governments would implement policies – things like tariffs – that impose costs on their trading partners. Some of these costs are externalities – these are costs that the country is not thinking about when it makes its tariff decisions. The economic purpose of the WTO is to get rid of those costs.

Let's be specific and walk through a trade policy example to really understand how this international externality can come up. Let's suppose I'm the European Union. You're the United States. You export automobiles to me and I, the European Union, I'm thinking about imposing a tariff.

Bob Staiger: Well, European Union will be thinking about its own interests and how that tariff affects its import-competing car producers and its workers and various other things. But what it's not probably thinking about is how the tariff is impacting the US. And on the US side, the car producers who were exporting cars to Europe are going to be hurt by those tariffs. And the workers who are working in the industries that are producing cars and car parts for export to Europe are going to be hurt by those tariffs.

And that's an international externality that the European Union is not naturally going to take account of in its tariff decision.

Chad Bown: That international externality arises because, in the absence of a WTO, Europe imposes a tariff that is too high. If there were no forum for the US government to come to Brussels and tell the European Union – "Hey, you are hurting our car producers and our car workers!" – then the EU would naturally choose a tariff that doesn't take that foreign harm into account. The EU would impose a tariff that is just too high.

Bob Staiger: The forum that the GATT/WTO provides is exactly a forum where the US can give voice to those complaints to the European Union when the EU is making its tariff decisions.

Of course, if the US just says, "You're hurting us," then that's not going to affect the European Union's decision. So, the US has to have some way to make an offer to the European Union of something of value that the European Union will accept in exchange for lowering its tariffs from what it otherwise would choose.

Chad Bown: The US would need to make Europe an offer. Starting in 1947, that is how the GATT worked. Countries like the US and those in Europe would get together periodically in something called negotiating rounds to coordinate mutual tariff reductions.

Bob Staiger: It could well be that the US is also making tariff decisions of its own that are harming European Union interests. And it's exactly that reciprocal exchange of tariff cuts that the two countries could negotiate in a GATT/WTO forum that is the basis for the way that the GATT and the WTO internalize these international policy externalities.

Chad Bown: So, it seems like from the way we've framed it, that this negotiation *could be* beneficial to both countries, both the United States and the EU.

But how do we know? What would it take for us to be sure that there are gains to be made here and that we really do need a WTO to solve a problem?

Bob Staiger: That's an important question. And the reason that it's an important question is that there has to be some inefficiency that can be corrected by these negotiations if both countries are going to walk away happy, because otherwise you can't make the pie bigger and both countries can't get a bigger slice of the pie.

Unfortunately, the kind of international externalities that I'm describing are what economists call "pecuniary externalities." They travel through markets, and they travel through prices. They're different than the externalities that we might be considering in a global carbon agreement – where the externality travels through the atmosphere – that doesn't travel through prices.

In trade, these externalities that we're talking about here, when the European Union is imposing a tariff that is blocking imports from the US, and therefore hurting US car producers and US workers, that's traveling through trade and therefore traveling through markets.

But economists know that pecuniary externalities don't normally cause inefficiencies. So, the key remaining question is, "Where is the inefficiency that could create the basis for a mutually beneficial agreement in the GATT/WTO?"

And the answer is there is one special case where the pecuniary externalities associated with the countries' tariff choices do create inefficiencies. And that's when the country choosing the tariff is large enough in world markets to be able to affect foreign exporter prices.

Or in other words, the country has market power in world markets.

Chad Bown: This is incredibly important.

The key purpose of the GATT and WTO is to create a forum for big countries – that have buying power in world markets – to get together. In the absence of that forum, each country would implement its own import tariff that was too high. Each would impose a beggar-thy-neighbor policy that creates costs – an international externality – for its trading partner.

Chad Bown: So back our original example, I as the EU would have to be a big consumer of automobiles so that when I raised my tariffs, the impact on you, the American exporter, was that you had to accept a lower price for the cars that you're selling into my market. I'm a really big consumer of these cars.

Bob Staiger: Exactly. And what you've just described is the monopsony power of an import demander who's forcing down the price of the firms that are selling to it. And what that does in the international context is allow the EU (in our example here) to shift some of the costs of its protection onto foreign countries, in this case onto US producers, because the EU is getting a lower export price in exchange for the tariffs that it has imposed. And that international cost-shifting is very naturally going to lead the EU to choose higher tariffs than it otherwise would.

So at the end of the day, I would argue that according to the GATT/WTO, it's not about free trade, but it's about how much market access a country is comfortable providing to its trading partners once it is stripped of its international cost-shifting incentives.

PART II. RECIPROCITY, OR HOW THE WTO MAKES THIS WORK (14:34)

Chad Bown: The WTO is not about free trade. The WTO is about how much market access a country is comfortable providing to its trading partners, once the country is stripped of its international cost-shifting incentives.

Your research has done more than just motivate the existence of the WTO, it has actually looked at some of the specific principles that are embedded in the legal texts and how countries seem to operate. One of those is reciprocity.

Bob Staiger: Reciprocity is the GATT's way of neutralizing the international cost-shifting incentives of its member governments. And reciprocity is defined in an interesting way in the GATT/WTO.

You might think that reciprocity, as it colloquially is meant, would say we should have equal tariffs across countries. That essentially was the definition of reciprocity that the Trump administration was hoping to achieve.

But GATT and the WTO define reciprocity in a very different way. Jagdish Bhagwati, among others, once defined it as "first-difference reciprocity."

It's about reciprocity and *changes* in tariffs, not the levels of tariffs. And in particular, reciprocity is thought to be satisfied within the GATT/WTO when one country's tariff changes, when combined with the tariff changes of its trading partners, lead to a change in the volume of its imports which is essentially matched by the change in the volume of its exports.

Chad Bown: The economics of reciprocity then – in the context of the WTO – is that a tariff change by me and a tariff change by you lead to equal changes in our imports and exports with respect to each other.

Now there are multiple places in the WTO, and the GATT before it, where this might come up.

The first would be when countries are thinking about *lowering* their tariffs – i.e., reducing their tariffs. Countries want reciprocal outcomes at the end of one of those negotiating rounds.

Bob Staiger: When countries are thinking about lowering their tariffs, they typically seek reciprocity in the outcome of the negotiation. For example, if the EU is going to lower its tariff on imported cars, it would like to find tariff changes from other countries that would ensure that the increase in its import volume is matched by the increase in its export volume to those other countries.

That kind of balancing is going to change the calculation of the tariff choices of the EU, when compared to its unilateral tariff choice. Because now if the EU agrees to lower its tariff on car imports from the US, it's giving up some of the cost-shifting, and those exporter prices from the US are going to tend to rise. And when the US is lowering its tariffs reciprocally on imports from the EU, those exporter prices from the EU to the US are going to rise.

And those two things, from the EU perspective, can just offset each other so that the EU no longer has any net incentive to be raising tariffs in order to shift costs onto other countries.

And notice that the amount by which the EU is incentivized to lower its tariffs on cars is all about one thing. And that is the market power that it was exerting, and the cost-shifting that it was initial engaging in via its initial tariff levels. And that's exactly what should be given up in a negotiation – it’s that part of a tariff.

What's left is then the underlying domestic incentives that the EU has to impose tariffs on cars, and on the flip side, the underlying domestic incentives that the US might have to impose tariffs on EU exports.

And that's why, even at the end of those negotiations, you may not end up with free trade on either side of the market. What you do end up with is the underlying domestic reasons for tariffs that countries are imposing.

Chad Bown: Countries may impose tariffs for domestic reasons – maybe a government wants to use a tariff to redistribute income from consumers to some companies or some workers. Maybe this was the result of the government being lobbied. Or maybe – as Bob mentioned is the case for a lot of developing countries – an import tariff may be the most efficient policy instrument the government has to raise tax revenue. The point is that *that* is a country's own sovereign domestic business. That part of the tariff remains.

But what reciprocity does get rid of is the other part of the tariff – the international externality part coming from importing country's market power – that imposed a cost on trading partners.

A second place where reciprocity comes up is when countries want to raise their tariffs. Maybe because something unexpected changed at home – the government needs to increase a tariff – but the country still wants to follow GATT/WTO rules.

Bob Staiger: Reciprocity plays a very important role in this second circumstance. And this circumstance is critical because, as was anticipated by the GATT and the WTO design, circumstances change. After negotiations have occurred, we know the world doesn't stay the way it was, and countries may want to rethink the commitments that they made in terms of market access.

And so importantly, a question arises as to what are the procedures by which countries can move away from the commitments they made at an earlier stage?

In the legal literature, there are two ways that a commitment can be protected. It can either be protected as a "property rule," meaning that if two countries (or two people) negotiate some contract, then one side of that contract can't get out of the contract commitments unless the other side agrees to let that happen. And that's a property rule which can make renegotiation very difficult.

A second way that the contract can be protected is through a "liability rule." And under a liability rule, if one side of the contract wants to get out of that contract, it can do so as long as it is willing to pay a particular price that is specified.

In the GATT/WTO, that price is reciprocal withdrawal of market access commitments on the other side.

As long as a country is willing to let its trading partners raise their tariffs reciprocally, if it wants to raise its tariffs, it can go ahead and do that.

Chad Bown: The WTO has multiple places where countries are allowed to raise their tariffs, subject to certain rules.

An important one is GATT Article XXVIII: Modification of Schedules. That is the part of the WTO that a country can use when its government needs to back away from an earlier market access commitment.

Here, there is a liability rule and it is reciprocity. How would that work?

Bob Staiger: The way it would work is if a country felt, because of some new developments, that it needed to raise its tariffs and reduce the market access that it originally committed to – it is free to do that, but it can't do that in isolation. And that is very important because if it could do it in isolation, we'd be right back in the unilateral cost-shifting problem that the GATT/WTO negotiations were supposed to solve.

If the US decided that it wanted to raise its tariffs on imported steel, and there were no possibility of foreign countries to respond to that, the US could go ahead and raise its tariffs on imported steel and lower the costs of steel into its markets and therefore shift some of the costs onto foreigners.

The WTO allows the US to go ahead and raise its tariffs on steel. But in doing that, the WTO allows other countries to reciprocate. And what that does is it faces the US with the right incentives to decide whether it really does want to raise those tariffs on steel.

Those incentives are right because, while the US raising of a tariff on steel might well lower the exporter prices of steel into its market, other countries are going to be able to reciprocally raise their tariffs on US exports – that's going to lower the US exporter prices into *their* markets. And under reciprocity, those two effects essentially balance out.

And so, under the reciprocity norm, countries face the right incentives to decide whether they truly want to back off on their commitments. Those incentives are going to be colored by their own domestic situations, but not by the international cost-shifting incentive, which is the source of the inefficiency that the WTO is trying to correct.

PART III. THE ECONOMIC EVIDENCE (23:58)

Chad Bown: We have this amazing economic theory motivating the WTO and its principle of reciprocity. Bob's book makes this case intuitively, but also using formal economic models and lots of mathematical equations.

Next, I wanted to turn to the evidence. There are lots of places to look for whether the evidence confirms or rejects this theory that the WTO solves the market power and international externalities problem.

To start, there are the tariffs of countries who were not part of the WTO.

Bob Staiger: First we want evidence that when countries are unconstrained by a trade agreement, they have market power and they use it when choosing their tariffs. This better be true because if that's not true, then there's no inefficiency created by the pecuniary externalities of tariff choices, and there's nothing for a trade agreement to do.

So, there is evidence of this, but as you might imagine, you have to look in the right places. In today's world, most countries are members of the WTO – 164 of them.

We have to go back in history at least a little bit to find countries who were not constrained by trade agreements, in particular by their WTO membership. And we can do that. China and Taiwan joined the WTO in 2001, Saudi Arabia joined in 2005, Ukraine joined in 2008, and Russia joined in 2012. There are a host of countries that were not GATT members originally and were not members of the WTO when it was formed in 1995. So those are the places where one would want to look with the data that we have to see whether those countries had market power in their unilateral tariff choices, and whether they used it to set their tariffs.

Chad Bown: When looking at the tariffs those countries were setting before they joined the WTO, what was the evidence? Did market power matter?

Bob Staiger: The evidence is pretty strong that market power does exist. And in fact, it exists in some surprising places. It's not only China, and the Chinas of the world, that are large, that seem to be able to exert their market power with their tariffs. But even countries that are relatively small on the world stage – e.g., Saudi Arabia, Ukraine – tend to be big in at least certain sectors and certain regions and have enough size to be able to exert market power when they choose their tariffs. And the evidence suggests that the tariffs that they did choose before they joined the WTO did in fact reflect that market power.

Chad Bown: That's evidence from countries not yet in the World Trade Organization. Now, once countries are in the trade agreement – and you pointed this out – the thing that we're looking for, whether they're exerting market power through their tariff choices, if the WTO is doing its job, that should disappear. So, we shouldn't find it. So, we shouldn't look there either.

But what about through the process of countries negotiating to get into the trade agreement? Is there evidence from that setting?

Bob Staiger: So, here again, there is evidence, but you have to look in the right places. And in this case, the issue is that there have been eight multilateral negotiating rounds that were sponsored by the GATT, with the final round, the Uruguay Round, creating the WTO.

And all along countries who were members from the very first round in 1947 have been liberalizing their tariffs. So, it's a subtle question as to how much of the liberalization that occurred was taking account of the market power effect of those countries, and how much was taking account of other things. And that's what we want to know is whether that liberalization can be explained by the market power of those countries.

One way to get around that is to focus on these very same countries that I mentioned a minute ago – the Chinas, Taiwans, Saudi Arabias, Ukraines, Russias, etc – that joined the WTO after its creation in 1995. Because one could argue that by the time the WTO was created, the member countries who had been members of the GATT had done a lot of liberalizing, and most of the liberalizing that they were going to do on goods.

They were asking the new members, in a one-off negotiation, to get rid of all of the bad parts of the tariffs that are supposed to be gotten rid of in the WTO.

Chad Bown: What did you find? For all of those countries acceding to the WTO after 1995, were the bad parts of their tariffs – the parts that they got rid of through accession negotiations – were those related to their market power?

Bob Staiger: We found that there is quite a strong positive correlation between the market power that the countries who were joining the WTO had, in terms of the sectors that they were offering tariff cuts on, and the size of those tariff cuts.

Sectors for a country that is quite small and didn't seem to have much power over foreign exporter prices – they didn't do much tariff cutting. And in a way that makes sense because the only way that countries are going to be asked to cut the tariffs is if there's some exporter out there who cares enough about that tariff to tell its government that that tariff should be cut, and that's something that that government needs to do.

At the end of the day, for those countries and those sectors, what seems to be left is not free trade – there's lots of variation in the tariffs that that remained after those countries joined the WTO – but what seems to be extracted from the original tariffs is the component that reflected market power.

Chad Bown: There is evidence for countries outside of the WTO, that the size of their tariffs at the time reflected their market power. Then, when they accede and join the WTO, there is additional evidence that that market power gets expunged through the tariff reduction requests that existing WTO members made.

Next, let's turn to the evidence on reciprocity under the GATT.

There are at least two places during the GATT period where we can look for evidence on reciprocity – as the outcomes of the negotiating rounds as well as the actual bargaining behavior of countries during those rounds.

Let's start with the outcomes of the negotiating rounds. Does the evidence suggest that bargaining outcomes were reciprocal?

Bob Staiger: There is evidence that bargaining outcomes do conform to a definition of reciprocity that's broadly consistent with what we've discussed here. And that evidence is there for the US and for the EU in the Uruguay Round, and it's there for other countries that have been looked at as well.

And what this evidence amounts to is looking to see whether the negotiated tariff cuts that countries agreed to have led individual countries to anticipate increases in their import volumes that are approximately equal to the increases in their export volumes.

In fact, historically, for example, the US routinely did reciprocity calculations at the end of each bargaining round in the GATT to see whether reciprocity was indeed satisfied by the bargaining outcomes.

Chad Bown: In the early days of the GATT – like during the Torquay Round in 1951 – the State Department was negotiating for the United States, the office of the US Trade Representative wasn't established until 1963. Later, the International Trade Commission, or ITC, was also involved in the assessments of the rounds.

To look for evidence reciprocity, what sort of calculations were these government agencies doing and why?

Bob Staiger: The ITC has done these calculations and before that, the State Department did these calculations and there were some relatively sophisticated attempts to make these calculations that took account not only of the direct effects of tariff cuts that the US had bargained with certain trading partners, but also the indirect effects that third-party bargaining in the round would have on US exporters.

The State Department did these calculations and said 10 percent of the export increases we're going to get are due to third party bargains in the Torquay Round – e.g., Germany and France are negotiating something, but we're going to get MFN, that's part of our exports, and they're adding up how much our export volume is going to increase versus how much we import.

The ITC did actually try to use elasticities and try to actually calculate what do we anticipate will be the change in our exports and the change in our imports, by sector, from these rounds.

And one could argue, well, it was partly for political cover that Congress wanted – this was supposed to be reciprocal. And they, they wanted to make sure, we can say that, "Yes, our exports are going to expand by as much as our imports."

Chad Bown: Reciprocity was an important outcome of the negotiating rounds.

A second place that reciprocity could also be important was as a norm that shaped the bargaining behavior of countries during these GATT rounds. Just thinking about it – in principle at least – countries could pursue all kinds of negotiating strategies. Maybe they make a low-ball offer and see what they can get for free. Or maybe they act tough.

First, can you explain the basic theory of how reciprocity was expected to work in creating a norm for trade negotiating behavior under the GATT.

Bob Staiger: If countries are holding themselves rigidly to a reciprocity norm – that they're demanding reciprocity as an outcome of their bargain – and if they're also bargaining under an MFN restraint that says the tariffs we bargain over are nondiscriminatory (they're MFN tariffs), then it turns out that that can go a long way to killing the strategic incentives that countries might otherwise have to make low-ball initial offers to try to act tough in a bargain in order to get a better deal.

And the reason is very intuitive. If reciprocity is the norm that says, “”I expect that whatever we agree to, if I'm going to cut my tariffs, you're going to have to cut your tariffs in a reciprocal way.” Then, there's very little else to bargain over.

It's not like I can say, “I'm going to hope that if I offer you a low-ball tariff cut of my own, I can force you to give me a big tariff cut,” because that would violate reciprocity. If we've come into negotiations already agreeing that reciprocity is the norm, then that kind of strategic behavior should fall by the wayside, and we should just cut right to the chase.

Chad Bown: So that's theory. But what happened?

How are researchers able to even examine bargaining behavior during those GATT rounds of negotiations?

Bob Staiger: In most situations you do not get data on actual bargaining between parties.

In the GATT rounds, and as I mentioned, there were eight of them, the actual bargaining that occurred, especially for the older rounds, was all done not on computers and not with tablets, but on legal pads and paper.

All of the offers and counteroffers were painstakingly written down, sector by sector, product by product, country by country, and exchanged in physical form between the countries in their bargaining.

The WTO website actually has many of the rounds of bargaining data up. These are in PDF form. They're in the raw form that the countries actually bargained. They are in different languages, different industrial classifications, they are not easy to use, but they can be used. And there has been research that looks at one of the rounds, which is the Torquay Round from 1950-51, and the bargaining data in that round.

Chad Bown: You have this incredible data from 1951 of the offers and counteroffers being made in the Torquay Round. So, what do you find? Does the bargaining behavior look like what we might expect if it were satisfying the GATT norms of reciprocity and MFN?

Bob Staiger: The short answer is, in many striking ways, it does. In particular, there's a striking lack of seeming strategic behavior, in the sense that the first offers that are made by countries are essentially their last offers.

Countries do not seem to make low-ball offers at the start and then – through the back and forth of the bargaining, over the months of the Round – finally get to some middle ground between what one country started with and another country started with.

Instead, each country, for the most part, seems to make its initial offers as those offers that it truly wants, without any kind of strategic interaction.

Then, the back and forth is really more about making sure that reciprocity ultimately holds. Because you, Chad, might come to the table hoping for a really big deal, a reciprocal deal, but a really big tariff cut. And I might come to the table, on this bargaining with you, hoping for a much smaller deal.

So, we do have to figure out who's going to prevail on that basis. But in terms of the balance of the deal, we're not bargaining over reciprocity. That's just a norm.

Chad Bown: For countries negotiating under the GATT, reciprocity was the norm.

Another way to see this was through the bargaining behavior of new countries. The Torquay Round was the third time that countries were getting together to negotiate under the GATT.

How did countries who were new at the negotiating table, joining for the first time during the Torquay Round, how did they bargain differently when it came to this reciprocity norm?

Bob Staiger: Interestingly, it was noted at the time of the Torquay Round that there were some new members who were joining that didn't necessarily understand the way that the bargaining worked under reciprocity and MFN in the GATT. And those countries included Austria, West Germany, Korea, Peru, Philippines, and Turkey, who were joining the GATT during the Torquay Round.

Those countries came into the bargains thinking that these were like normal bargains where they could make low-ball offers and hope to be tough and get a good deal. And they failed to do that. And they either had to walk away with a small trade deal – because others took their offers at face value – or they had to give up on their strategizing and just reveal what they actually wanted, just like the other countries.

Chad Bown: There is lots of evidence then that the WTO would sort of line up with how economists think about it, including through reciprocity. But is the evidence universal?

Bob Staiger: I would say that the evidence is strong but not universal. And a good example of counterevidence, or at least seeming counterevidence, is in the recent Trump trade wars.

In particular, there's been a lot of studying of the foreign exporter price effects of tariffs that were imposed both by the US and by China, and by other countries as well.

What this evidence seems to suggest is that, at least so far, it is very difficult to find depression of foreign exporter prices that result from tariff increases.

That would run counter to the evidence that I've been talking about in the context of trade agreements. And it would be a serious challenge for the view that the WTO, and GATT before it, exists in order to eliminate the incentive that countries have to use their market power to depress foreign exporter prices.

Chad Bown: Under this view that WTO negotiations lead countries to constrain their tariffs in ways that limit their market power, we might have expected foreign exporters to lower their prices when hit with the new trade war tariffs. And we are not yet seeing a lot of evidence of this.

What are some other potential explanations for these puzzling results?

Bob Staiger: Partly the evidence is very short run as it has to be because we haven't had a lot of time since the Trump trade wars to look at the data.

Secondly, a reasonable interpretation of the Trump tariffs themselves is that they were always meant to be temporary and used as bargaining tariffs to try to get other countries to lower their tariffs. And to the extent that they were viewed as temporary, then the exporter price effects of those tariffs are not nearly as clear as they would be if these were expected to be permanent.

But the short answer is that this new evidence raises questions that still need to be sorted out. And over time, that process of sorting out will help clarify how this evidence fits with the earlier evidence.

And as an interesting aside, of course, President Trump certainly believed that foreign exporters were going to pay the cost of these tariffs. It's simply that the economic research that has been done on his tariffs don't support that view.

PART IV. CHINA AND THE WTO (42:34)

Chad Bown: President Trump's trade war with China has kicked off a tense period in trade relations, not only between China and the United States, but also for the WTO. There have been calls for the US and China to decouple.

Some have even proposed kicking China out of the WTO. The argument is that the WTO can't work for a non-market economy like China, a state-run economy with lots of subsidies, state-owned enterprises, five-years plans, and industrial policy.

We're going to focus purely on the issues associated with China being a non-market economy. For now, we are going to put to the side what might be legitimate concerns over democracy or human rights, or China's use of trade policy as an instrument of economic coercion. The big question for the trading system is, can the WTO potentially accommodate non-market economies like China?

Bob's answer may surprise you.

Bob Staiger: Once we take the view that it's not about free trade, but about how much market access a country is comfortable providing to its trading partners once it's stripped of its international cost-shifting incentives, accommodating a non-market economy, such as China, becomes quite consistent with the WTO principles.

Chad Bown: Accommodating China could be consistent with WTO principles – but it won't be easy. It will require some work. Making progress though requires understanding exactly what it is about the current market access approach of the WTO that doesn't work, when it comes to China.

Bob Staiger: Of course, there are immense challenges.

The GATT and the WTO were created with market economies in mind. And the rules of the GATT/WTO are built on the principle that, when a country cuts a tariff, that tariff cut has price effects, which are going to lead consumers and firms to do certain things that a market economy would predict they would do.

And in a non-market economy, that link is severed. And when that link is severed, that creates a problem for the GATT or the WTO.

But that problem is not as fundamental as many people think, I believe. Because ultimately, China has the same possibility of exerting its monopsony power on foreign exporters to lower their costs, and therefore has the same temptation to engage in international cost-shifting through its policies, as does any other country.

It's just that within China's borders, the amount of production and consumption, and therefore the volume of its imports and the volume of its exports, those things are not determined by price signals in the way that they would be in a market economy.

Chad Bown: Why is this potentially not a problem for the WTO?

Bob Staiger: The problem is not the market access focus of the WTO in terms of its commitments. The problem is how to get China to honor its market access commitments, when it's not a market economy. And the structure of the GATT/WTO is to allow countries to make market access commitments through tariff cuts and through other rules – the Articles of the GATT and the WTO that shore up those tariff commitments in terms of their market access implications.

Chad Bown: For market economies – like the United States or Japan or the EU – those other Articles of the GATT and WTO have typically been enough. One WTO member can translate whether another is living up to its market access commitments for the most part by looking at their policies. Whether their tariffs and their subsidies are following the rules is usually enough to tell us whether they are following through with their market access commitments.

But for China, that has not been enough. Because China is a non-market economy, commitments over its tariffs and other WTO rules did not lead to reciprocal market access.

So, what should countries tell China?

Bob Staiger: The first thing that I would say is that it is not the case that China should be told that its non-market features are incompatible with WTO commitments.

Rather, what China should be told is that, like every other WTO member, it needs to honor its reciprocal commitments and in particular, its reciprocal market access commitments. And so, it needs to find a way to make those reciprocal market access commitments in a credible way. And so far, I think many observers agree that the Articles of the WTO, and the GATT before it, are not working to deliver that.

So that raises the question, what would work to do that? Well, first of all, that's a very different question than the question that many observers I think are raising, which is, if China can't evolve toward a market economy, it has no role in the WTO.

So, for the question that I'm raising, China could continue to have its own economic system as it chooses, but it needs to find ways to make credible market access commitments.

Chad Bown: If the goal is to get China – a nonmarket economy – to make secure market access commitments, there is an historical precedent in the multilateral trading system.

Bob Staiger: Here history provides an interesting example. China is not the first non-market economy to join the GATT or the WTO. There were a number.

One interesting example is the case of Poland who joined the GATT in 1967 at a time when Poland was not expected to evolve toward a market economy. Poland and the rest of the GATT members had to figure out a way that Poland could make market access commitments that would satisfy the reciprocity norm that all GATT members had to satisfy. And the way that this was solved, in the case of Poland, was a very simple one- or two-paragraph accession agreement that essentially said that Poland agreed to a quantity commitment – i.e., to grow its imports from member countries of the GATT by a certain percentage per year that reflected the expectation of member countries of how much Poland's exports would grow to them.

That is the reciprocity norm that countries are trying to achieve, whether they are market economies or non-market economies in the GATT.

Now, that said, Poland was a medium-sized, non-market economy at the time. China is a very large non-market economy. I'm not suggesting that one could adopt the solution that was adopted by GATT for the case of Poland and simply apply it to the case of China.

But what does seem indicated by that example is that non-market economies can indeed be good citizens in the GATT and the WTO. And the key is that they find ways to maintain reciprocity, and reciprocity of market access commitments, and there is nothing about whether the economy is a market economy or non-market economy that necessarily precludes that.

Chad Bown: Building on the example of Poland's agreement to join the GATT in 1967, part of the answer may be for China to grow its imports from WTO members by the same amount that it is growing its exports.

Though this sounds similar to President Trump's "Phase One Agreement" with China in 2020, it would be different in some very important ways.

Bob Staiger: It's interesting to think about what the Trump administration was trying to do here.

They did try to force China to abide by quantity commitments to increase imports from the US. But here, I would say there were several very important differences.

One was these were commitments that were of a bilateral nature and not a multilateral nature. They were commitments that China was being asked to agree to on US exports to China. And that is very different than a multilateral commitment that China might make in the context of WTO negotiations, where it makes commitments to market access and increased imports from WTO member countries as a whole.

It's also true that the Trump attempt was not a rules-based attempt in any sense of the word in that it occurred in the context of the Trump trade war. And that is a very different environment than what would be a typical negotiation in a WTO context.

Chad Bown: So, this would not be a commitment by China to buy an additional $200 billion of exports from the United States alone. The reciprocal market access idea here is to make sure China's import increases from the world are balanced with its increases in exports.

Bob Staiger: And let me be clear, I'm not advocating that a quantity agreement is the right way to go for China. I think the more important point is that once one accepts the view that a necessary condition for China to be a good WTO member does not necessarily mean it has to relinquish its non-market system, then many things may be possible.

And China itself may know the best way to make these market access commitments if it's pitched in a way that says China is just being asked to do what every other WTO member country does, which is to abide by reciprocity in its market access commitments.

Chad Bown: For a WTO desperately in need of new negotiating approaches, this is a super interesting idea.

I will write it up, hand it to USTR, to DG trade in Brussels, to MOFCOM and the Chinese negotiators in Beijing, to the folks at the WTO Secretariat in Geneva, and see if this might at least get them back to the negotiating table.

PART V. WTO RULES AND POLICIES TO TACKLE CLIMATE CHANGE (53:23)

Chad Bown: Climate change is another problem that Bob grapples with in his new book.

Climate change is one of the biggest global policy issues of our time. Some have argued that WTO rules are outdated – that WTO rules are simply too tight and discourage countries from adopting domestic clean energy policies like carbon taxes.

To Bob, some potentially very important climate change mitigation policies – like carbon taxes – could achieve their goals without causing problems for the WTO.

Bob Staiger: I think the observation that the WTO commitments are about market access rather than a commitment to free trade is really important here. And the reason is that when countries are faced with a climate issue, like global warming, and need to think about domestic policies that might address that issue in the WTO, they're not necessarily wedded to the existing tariff commitments that they've made.

Instead, what they are wedded to is the existing market access commitments that they have made. And as we've talked about, if they want to renegotiate those, they can do so.

But when a country considers – as, say, the EU is considering – imposing carbon taxes or the equivalent on its producers, that's going to have market access implications for the existing tariffs that the EU has committed to. And in particular, it will likely disadvantage EU producers and, at the existing tariffs, lead to what economists call "carbon leakage" – i.e., movements of production of the dirtier goods that the EU produces out of the EU system, and into countries that perhaps don't have those carbon taxes or that are using dirtier technologies.

Chad Bown: That fear of carbon leakage may be preventing the EU and other countries from imposing domestic carbon taxes in the first place.

And the source of that fear makes sense if the EU thinks it can't change its import tariffs.

Bob Staiger: And so if the EU were held to the tariffs that it had committed to in WTO negotiations, when it imposes a system of carbon taxes, it would actually be being asked by its WTO tariff commitments to now offer *more* market access than it had originally because it is disadvantaging its domestic producers with these carbon taxes at the expense of foreign producers.

And I don't think that reflects the logic of the market access commitments that the WTO tries to administer. In particular, there's an opportunity here for the EU to raise its tariffs to offset the competitive effect of its carbon taxes. And, in a sense, that's very similar to what we might think of as a carbon border adjustment.

But there are some differences that are important in what I've just said relative to, say, the current CBAM proposal of the EU. And a key difference is that what I've just described is the possibility of an *MFN* tariff increase that the EU could impose – as it imposes carbon taxes – that would offset the market access implications of its carbon taxes.

Chad Bown: Take a heavy carbon-emitting industry like steel. Suppose the EU imposes a carbon tax on its steel industry – then, the industry's costs go up. For the same amount of local demand in the EU, if the EU's import tariff is unchanged, then, the local steel industry's costs going up will lead to an increase in EU steel imports. The EU has inadvertently increased its market access. That is basic Econ 101.

Bob Staiger: So if the EU were to impose carbon taxes in a way that disadvantaged its steel producers, under this thinking, the EU could raise its MFN tariff on steel to just offset the disadvantage that its steel producers were now facing because of the carbon tax and preserve the market access that it had originally, before the carbon taxes were imposed, offered to other countries.

Well, that's very consistent with the market access orientation of the WTO, and I don't think there's anything that would argue for a carbon border adjustment that were designed in that kind of way – i.e., to just maintain the market access commitments of a member country.

What might be more controversial, and what the EU CBAM proposal seems to be leaning toward, is to make those carbon border adjustments a function of the carbon of the foreign exporting countries. And notice that what I said was that the MFN tariff that the EU could raise would be WTO-consistent, in my view, if it raised its MFN tariff in a way that just offset the market access implications of its carbon tax.

Well, that depends on how dirty the production is within the EU because those are the firms that are going to have to pay this carbon tax. And the dirtier the industry, the higher the tax they are going to have to pay. And that would suggest that for those industries, the MFN tariff adjustment should be higher as a result.

But that has nothing to do with the dirtiness of the production outside of the EU. If the MFN tariff is raised to offset the market access implications of the carbon tax within the EU, foreign exporters – whether they be from China or from India or from the US, and whether their exports are dirty or modestly dirty or clean – should have no bearing on the tariff they face selling into the EU.

Chad Bown: One type of carbon border adjustment would seem to be completely WTO consistent – this MFN kind – at least from the perspective of countries making market access commitments through the WTO.

What is likely to be more controversial from the perspective of the WTO's current rules are other CBAM approaches that would differentiate between foreign sources based on their carbon emissions.

Bob Staiger: That latter dimension, if you were going to use your tariffs to actually incentivize the dirtiest countries who are selling to you to clean up their act – that's part of what the CBAM proposal seems to be aimed at – and I think that's a more controversial dimension of carbon border adjustments, because it doesn't just offset the market access implications of the carbon tax for a country. But in fact it uses the border adjustments to try to incentivize other countries to clean up their act in terms of carbon emissions as well.

I think the EU believes that its CBAM proposal will be WTO-consistent, but that hasn't been tested in the WTO. And my own sense, as an economist, is that I think an MFN carbon border adjustment of the kind I first described would be perfectly consistent with WTO rules. But a carbon border adjustment that was based on the carbon content of the foreign exporting country is likely to face greater challenges in the WTO.

And in part this is because countries like China and India feel that this would be an illegal way for the EU to discriminate against them for a purpose which falls outside the fundamental market access focus of the WTO, namely to help solve the climate problem.

And I think one can argue whether that purpose itself is legitimate or not, but in my view, it does fall outside the market access issues that are the central purpose of the WTO.

Chad Bown: To be clear here, Bob is not advocating for one type of CBAM over another to address the climate problem. What he is explaining as an economist is that there is a key distinction between the two from the perspective of the current WTO rules and norms that member countries have already agreed to.

Bob Staiger: So, let me summarize and be clear here. I'm not saying that using tariffs that are based on the carbon content of a foreign exporter is necessarily not something that countries want to do in order to help solve the climate problem. What I am saying is, I think it's very useful to separate these two issues.

First, using tariffs to just offset the market access implications of your own carbon taxes – and there I think those tariffs could be MFN and they could be completely non-controversial in terms of WTO rules and rulings.

Second, the more controversial issue is, do you want to use your tariffs to incentivize other countries to clean up the carbon in their production?

I think by identifying those two issues, one could at least separate out the non-controversial part and allow some carbon taxes to go through without any qualifications in the WTO. And then the question is left for the more controversial aspects of those carbon taxes.

Chad Bown: Let's turn to proposals that are even more controversial. William Nordhaus has a proposal for a climate club. There are different versions, but the rough proposal has the cool kids in the club with low carbon emissions applying low import tariffs toward each other, and countries with higher emissions outside the club would be hit with higher import tariffs.

The motivation is that the climate crisis is so important, governments need to do everything they can to try to incentivize high-emitting countries to reduce their carbon emissions.

Bob Staiger: The Nordhaus climate club proposal is a good illustration of the point I'm trying to make. I think that proposal, which would essentially have countries agree to a common set of carbon policies and then low tariffs among them – with the idea that countries that don't agree to those policies would face very severe tariffs – that seems very clearly to me to be in violation of many WTO obligations.

Now, that said, it could be that the severity of the climate problem warrants that. So, I'm not saying that that's not necessarily something that ultimately shouldn't happen.

What I am saying is that there are a number of important things that could be done on climate policy that are not inherently inconsistent with the WTO. And the attempt to use carbon border adjustments to offset the market access implications of a country's own carbon policies is something that I think is fully consistent with WTO policies if done in the right way.

Chad Bown: As my last question for you, there are a lot more examples in your book about new, twenty-first century issues. We haven't had time to go through them all, but things like global value chains, services trade, digital trade, and lots more. If you had to summarize where you would come down on the role of the World Trade Organization in tackling the litany of new issues that are out there today, what would you say?

Bob Staiger: I would say that there is a strong basis in economics for the legitimacy of the GATT/WTO to serve as the constitution of the world trading system. And there's a lot at stake in that statement because while the features of the GATT/WTO reflect the shallow approach to integration that the GATT/WTO has adopted – focusing on market access commitments and on negotiations over tariffs and other border measures as the primary means to make those commitments – there are alternative approaches out there that focus on far deeper forms of international integration, such as some of the mega-regional agreements that have been in the news more recently that require countries to negotiate over many behind-the-border policies that have been traditionally considered the purview of national governments.

Therefore, there's a real choice facing the world, in terms of what constitutes the best design for trade agreements. And while the GATT/WTO is far from perfect, I'm arguing that from economic principles, it has a strong claim on legitimacy that should not be dismissed lightly.

Chad Bown: So, if you had a motto for the way that policy makers should think about the WTO as we address these twenty-first century challenges, what would it be?

Bob Staiger: What I would not advocate is Mark Zuckerberg's famous statement, "Move fast and break things."

But instead the motto I would probably embrace would be the now ubiquitous motto from Britain in World War II, which is, "Keep calm and carry on."

Chad Bown: Bob, thank you very much.

Bob Staiger: Thanks for having me.

CONCLUSION (1:07:25)

Chad Bown: To wrap up this episode, I wanted to share two other things.

First, Bob Staiger was my graduate school advisor. Bob was a professor when I was at the University of Wisconsin as a PhD student in the 1990s, so I have known Bob for almost 30 years.

Bob was the best sort of advisor. I am one of many of his former students who would all probably say the same thing. He is not only a clear thinker and remarkable contributor to the economics profession, but he is a caring and kind human being. He is an incredible role model. I am grateful for his support over my entire professional career.

This was therefore a pretty tough episode for me to do. Bob is pretty special to me. I wanted to make sure I got everything just right.

But second, I wanted to tell one other little story.

Chad Bown: This is a special treat for our listeners. Did you know you are the only economist to have made me cry?

Bob Staiger: Wow, I didn't know that. Did I give you really, really strong comments on one of your early chapters?

Chad Bown: I'm glad that you don't remember this story. This was my fourth year of graduate school.

My wife – an amazing woman, we have been married now a very, very, very long time – she was getting sick of the Wisconsin winters, and she had just gotten a job in Northern California, and I desperately wanted to go on the job market that year. And I came into your office, and I'd sent you papers ahead of time and you'd read them.

And I said, "Bob, am I ready to go on the market?"

And you looked at me kindly, and you said, "Chad, not yet."

And I, at least internally, broke down in your office. Devastated.

But you were right. I wasn't ready. I stayed another year and made my papers hopefully even better. But it was a memorable experience.

Bob Staiger: Wow. I had no recollection that I was so cruel in my younger years. I'm now apologizing to you.

Chad Bown: No, no, no. You did absolutely the right thing. If I had gone out in the market at that point in time, there may have never been *Trade Talks*.

Bob Staiger: A silver lining.

Chad Bown: A silver lining.

GOODBYE FOR NOW

Chad Bown: And that is all for *Trade Talks*.

A huge thanks to Bob Staiger at Dartmouth College. Do check out his brand-new book titled "A World Trading System for the Twenty-First Century."

TRADE talks

A podcast about the economics of trade & policy
with Chad P. Bown

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<insert super funny double underscore joke here>. ■

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Robert W. Staiger. 2022. *A World Trading System for the Twenty-First Century*. Cambridge, MA: The MIT Press.