

## B THE ECONOMICS AND POLITICAL ECONOMY OF INTERNATIONAL TRADE COOPERATION

### 1. THE HISTORICAL CONTEXT FOR THE FAILURE OF INTER-WAR TRADE COOPERATION

#### (a) Trade policy before World War I, 1860-1914

The rise and decline of free trade in the 19<sup>th</sup> century and the attendant economic and political consequences of these trends have always intrigued historians and economists. In the difficult times following World War I, when international trade relations had to be rebuilt, the free trade episode among European countries in the second half of the 19<sup>th</sup> century was perceived as a golden age. During that latter period, widespread economic development, driven by industrialization and technological change, went together with trade expansion supported by a network of bilateral trade treaties. This network started with the Anglo-French (Cobden-Chevalier) treaty of 1860 and triggered a series of other treaties among European countries. Bilaterally agreed reciprocal tariff reductions, together with the application of the unconditional most-favoured-nation (MFN) clause contained in the treaties, led to historically low tariff levels, in particular for agricultural products. This period of largely unfettered trade across Europe lasted for nearly two decades up to 1879, faltering gradually thereafter and collapsing with World War I.<sup>1</sup>

#### (i) *The emergence of a multilateral trading system with low tariffs in Europe*

In light of subsequent developments in international trade relations, it is interesting to note that no multilateral conference or international institution underpinned the de facto network of multilateral, non-discriminatory trade arrangements that emerged from the bilateral treaties among the leading trading nations in the late nineteenth century. These arrangements did not, however, constitute a global trading system with low protection levels – the United States and Latin American countries maintained a high tariff policy throughout this period. Moreover, trade between the colonial powers and the territories they controlled was largely bilateral and driven mainly by political factors which often led to a certain level of discrimination in trade and navigation policies. China and Japan, which had been closed economies in the first half of the 19<sup>th</sup> century were pressured into opening their markets to international trade between 1840 and 1860.<sup>2</sup>

The second half of the 19<sup>th</sup> century witnessed the spread of the Industrial Revolution to the European continent, the United States and Japan. A steady flow of innovations brought new and cheaper industrial goods to the market and sharply reduced communication and transportation costs. The impact of the telegraph, the railway networks and the steamship made international transportation not only cheaper but also more secure and faster. Markets for bulk commodities which had been separated in the past by insurmountable transport costs came increasingly into the reach of traders and stimulated production in regions of recent European settlements. These new opportunities attracted foreign investments and immigrants which accelerated the integration of markets on a global scale. The agricultural sector in the United Kingdom and on the European continent had to take the first brunt of market integration but with the spread of industrialization competition also increased among the industrial sectors of the European countries.

Throughout the 19<sup>th</sup> century a vivid theoretical and political debate flourished on the benefits of free trade. While the mercantilist's trade policies became largely discredited, the prescriptions of the classical

<sup>1</sup> For a detailed account of trade policy developments of the 1850-1913 period see Bairoch (1976), Bairoch (1989), Baumont (1952), Frieden (2006), Kindleberger (1975), Lal (2006), O'Rourke (2007), O'Rourke and Williamson (1999), Thorn (1970) and Woodruff (1971).

<sup>2</sup> China was forced to sign the treaties of Nanjing (1848), Tianjing (1848) and the Convention of Beijing (1860), which left its tariff regime under the control of foreign powers. Japan also faced pressure to conclude a series of trade treaties with the United States and major European powers from 1854 onwards (with Russia, the United Kingdom and the United States, in 1854, and with France, Holland and Prussia in 1861).

economists such as Adam Smith and David Ricardo in favour of unrestricted trade were opposed by other authors such as the American, Alexander Hamilton and the German, Friedrich List which recommended government intervention and a trade policy which should protect emerging domestic industry. The intellectual respectability of infant industry protection reached its zenith when John Stuart Mill, the pre-eminent mid-nineteenth-century economist, endorsed it in his major work "The Principles of Political Economy". Neither Friedrich List nor John Stuart Mill, however, recommended protection for the agricultural sector in any nation, nor did they argue for protection for Britain, the leading industrial nation of the time. Robert Torrens developed ideas akin to the optimal tariff argument, a notion that under certain conditions protection could improve national welfare. The strongest counter argument to these ideas is that of likely government failure. A government has not the foresight or the information to identify the industries worth supporting and is often not strong and independent enough to restrict protection only to those industries for which protection could lead to an increase in national welfare.

The United Kingdom played a crucial leadership role in the European experience. The Corn Laws were repealed in 1846, and other measures were taken to open up to trade, including the conclusion of bilateral trade treaties.<sup>3</sup> In the mid-nineteenth century, the United Kingdom was the undisputed technological leader in the industrialization process, most prominently with its textiles industry. It was the largest exporter and importer in the world, and possessed the largest commercial fleet.<sup>4</sup> The UK pound was the most widely used and accepted currency in the world and the United Kingdom had the largest stock of investment outside its home economy. The British currency and London's financial markets were the lynchpin of the gold standard to which adherence had been growing rapidly since 1872.<sup>5</sup> Since the end of the Napoleonic wars and the Congress of Vienna, the United Kingdom had entered a period of unprecedented political stability at home and in its relations with its European neighbours. With its competitive industry, the United Kingdom looked for export markets and in return was willing to accept agricultural products and raw materials on a large scale. The development of overseas sources of supply was supported in large measure by capital exports and immigration.

Why did other European countries follow the United Kingdom's lead to substantially lower their trade barriers? First, trade policy in Europe was a feature of more liberal, market-oriented domestic economic policy regimes.<sup>6</sup> Second, the United Kingdom offered the largest import market and even although trade barriers were low, the prospect of reducing them further and binding them through a treaty proved a worthwhile objective. Under the Cobden-Chevalier treaty, France benefited from guaranteed free entry for a specified list of manufactured goods, an 80 per cent duty reduction for wine and an exemption from the British export tax on coal. The United Kingdom secured the elimination of import prohibitions in France and their replacement by tariffs (with an upper limit of 30 per cent *ad valorem*).<sup>7</sup> Once France and the United Kingdom had agreed, a flurry of agreements followed across Europe. The United Kingdom had already applied its (low and mainly fiscal) tariffs on an unconditional MFN basis before 1860 and this clause was retained in the Cobden-Chevalier treaty.<sup>8</sup> According to Kindleberger (1989), the example provided by the Cobden-Chevalier treaty helped to win over the protectionist forces in Prussia, leading to a trade treaty between the Zollverein and France in 1865. Besides the economic considerations the Prussian government hoped to improve relations with France and garner support for its foreign policy

<sup>3</sup> The repeal of the Navigation Act in 1849 was a further major step in the liberalization of Britain's trade.

<sup>4</sup> The United Kingdom alone accounted for about one-fifth of world trade (see Appendix Tables 1 and 2).

<sup>5</sup> Between 1872 and 1879, nine countries started to apply and guarantee a gold parity for their exchange rate (Germany (1872); Denmark, Norway and Sweden (1873); Netherlands (1875); Belgium, France and Switzerland (1876) and the United States (1879); Frieden (2006: 6).

<sup>6</sup> Bairoch (1976: 57) reproduces a letter from Napoleon III to his Minister of State dated 5 January, 1860 in which he exposes his broad economic program including support to industry by lowering tariffs on imported raw materials and the stimulation of competition in the industrial sector by lifting various domestic restrictions.

<sup>7</sup> See Bairoch (1989). In 1860, the United Kingdom recorded a large bilateral trade deficit with France, which at that time imported few manufactured goods. The share of manufactured goods in French merchandise imports was a mere 3 per cent in 1860.

<sup>8</sup> Before the repeal of the Corn Laws, the United Kingdom tariff of 1842 contained preferential tariff rates for its colonies on one-fifth of its 1825 tariff positions (Nolde, 1932: 101).

over the Danish question and in isolating Austria.<sup>9</sup> In the case of Italy, agricultural export interests in the Piedmont region were a major factor in the adoption of a free-trade policy. Smaller European economies concluded trade agreements with France, thereby improving market access for their producers to the French market (which still had significant tariff barriers) and contributing to the creation of a low tariff area in Europe.

## (ii) *European free trade in decline, 1879-1914*

The European trade treaty network started to falter when the initial trade treaties came due for renewal in a changed political and economic environment. During the Great (European) Depression between 1873 and 1896, prices of internationally traded goods decreased steadily, falling by one-third over the period.<sup>10</sup> While the United Kingdom remained strongly committed to its free trade principles and low tariff policy up to World War I, countries in continental Europe which had large agricultural sectors and less developed industrial sectors started to increase tariffs.

The shift towards more protection was motivated by different factors, although a major one was the depression caused by the agricultural crisis in continental Europe. Following the end of the United States' civil war (1861-65), grain production recovered in the United States and exports rose sharply. Benefiting from falling transportation costs, other areas of European settlement overseas also expanded their production. The influx of overseas grain into Europe caused a widespread price decline.<sup>11</sup> Continental wheat farmers who had supplied the British market during the United States' civil war quickly lost this market to United States suppliers when the war ended. Woodruff (1971) estimates that "with the great increase in the world production of grain from the 1870s until the end of the century, the price of wheat dropped from about \$1.50 a bushel in 1871 to 86 cents in 1885; a decade later in 1894 the figure was about 70 cents."<sup>12</sup> According to Bairoch (1989), this inflow contributed to a slowdown in the growth of agricultural production in continental Europe and a fall in farmers' income. Farming still employed more than one-half of the active population in these countries (compared to 22 per cent in Great Britain when it abolished the Corn Laws in 1846).

The fall in farmers' income depressed demand for consumer and investment goods, which had adverse effects on other industries. Reduced domestic demand was not fully compensated by offsetting favourable developments such as a real rise in the incomes of industrial workers (due to a fall in living costs) or higher manufactured exports. Monetary factors, in the form of lower growth in international liquidity, may have also played a significant role after the gold rushes in California and Australia had run their course.<sup>13</sup>

Demands by agricultural lobby groups for stronger protection against highly competitive overseas supplies also encouraged others such as the iron and steel and textile industries to seek higher protection. The most prominent shift to a more protectionist trade policy in Europe was the rise of German tariffs in a customs law introduced in 1879.<sup>14</sup> The shift to a more protectionist German trade policy cannot be attributed solely to domestic producers as government interests also played a role. In the case of Germany, Chancellor Bismarck (previously a supporter of free trade) joined and united the protectionist forces in the hope that higher tariffs would increase central government revenues.

<sup>9</sup> It should be recalled that trade liberalization among countries had an important parallel within some countries. Within the German borders of 1871, more than 20 trade entities existed after the Congress of Vienna in 1815. These were gradually integrated through the formation and eventual merger of the Norddeutsche and Süddeutsche Zollverein. In Italy, national unification also resulted in the disappearances of independent autonomous trade entities.

<sup>10</sup> See Lewis (1981) Tables 3 and 4.

<sup>11</sup> After the spread of refrigeration techniques, a similar decrease in meat prices was observed.

<sup>12</sup> See Woodruff (1971: 662).

<sup>13</sup> See Baumont (1952).

<sup>14</sup> Bairoch (1989) reports that Russia, Austria and Spain were ahead of Germany in the move to a more restrictive trade policy, with various measures introduced in the course of 1877.

Continental European trade policy turned even more protectionist during the 1890 to 1913 period. The starting point might be fixed at 1892, when more than half of the 53 trade treaties of European countries had expired and nationalist sentiments had become stronger. The introduction of the so-called Méline tariff<sup>15</sup> in France provided additional protection to the country's agricultural sector and strengthened protectionist forces all over the continent. In addition to the rise in tariff rates, more detailed and complex tariff schedules emerged. The introduction of schedules with maximum and minimum rates increased the uncertainty to traders. The French minimum tariffs were reserved for countries that had agreed to a bilateral treaty but they remained subject to changes decided by the French parliament. In contrast to the conventional tariffs applied in previous commercial treaties, therefore, no stability in tariff rates could be assured for the duration of the treaty. While the increased detail of tariff schedules was partly driven by the emergence of a larger variety of traded goods, in particular manufactured goods, this increased detail in specifications was sometimes used as a protectionist device to discriminate against competing foreign goods.

As trade barriers in Europe increased, the direction of trade flows changed. The colonial European powers strengthened their trade ties with the territories they controlled. Colonial territories had become more valuable markets and sources of supply due to falling transport costs, rapid population growth through migration, and increased foreign investment.

Once protectionist forces took hold across many countries, governments could blame the behaviour of others to justify their own trade restrictions. The shift in German trade policy in 1879 had been justified on the grounds that the United States retained high tariffs on manufactured goods (Bairoch, 1976:59). Over this period there was also a shift in the relative size of various national economies, which on balance eroded the leading position of the United Kingdom. First, the rise of the United States was increasingly felt in international trade relations.<sup>16</sup> Second, national sentiments were strengthening, above all in newly-unified Germany (1871) and Italy (1870). These countries were trying to catch up with the United Kingdom not only industrially, but also in international policy by competing for colonies. Growing rivalry among the major trading nations was only partly contained, for example through the Berlin Conference on colonies. Strong animosity prevailed in France towards Germany due to the loss of territory (Alsace, Lorraine) following the war of 1870/71. In the two decades prior to World War I, a number of tariff wars broke out, usually provoked by the establishment of a new, more protectionist tariff, or in the course of renegotiation of bilateral treaties.<sup>17</sup> After the expiry of a treaty, tariffs were often raised temporarily as a means of improving negotiating leverage.

Other important trade policy developments should be flagged. New policy instruments were introduced in the form of anti-dumping and export bounties (subsidies). Following a series of international conferences, the first international commodity agreement – the Brussels convention on sugar – was signed in 1902. This convention sought to regulate global production and trade in this product.

The increasing departure from the MFN principle could also be observed in the emergence of preferential trading arrangements, such as those among some members of the British Commonwealth.<sup>18</sup> Despite the widespread increase of protectionist measures before World War I in continental Europe, the United

<sup>15</sup> Méline was the French agricultural minister and major promoter of the tariff.

<sup>16</sup> The share of the United States in world exports rose from 7.9 per cent in 1870 to 14.1 per cent in 1900 (see Appendix Table 1).

<sup>17</sup> France had severe tariff conflicts with Italy (1887-1910) and Switzerland (1893-95). Germany experienced the same with Russia (1893), Spain (1894-96) and Canada (1894-1910), and Austria with several Balkan states (e.g. Romania).

<sup>18</sup> Imperial preferences were introduced by Canada in 1897, by New Zealand and South Africa in 1903 and by Australia in 1907 (Nolde, 1932: 103).

States<sup>19</sup>, Argentina and other countries, world trade continued to expand rapidly.<sup>20</sup> Among the factors which balanced the adverse impact of these protectionist measures was broad adherence to the gold standard in the latter part of the period, rapid technological progress, which continued to reduce transportation costs and a marked rise in migration flows and foreign investment. Finally, the recovery in prices of internationally traded goods from 1896 onward attenuated the *ad valorem* incidence of specific duties.

## (b) Trade policy turmoil in the inter-war period, 1918-39

During World War I, international trade relations based on private commercial transactions were replaced by extensive government controls, as output was dedicated to support national war efforts. Sea blockades and submarines curtailed overseas trade. High tariff levels, quantitative restrictions and prohibitions on both exports and imports, combined with foreign exchange controls, increasingly dominated the policy scene. At the Allied Economic Conference in 1916, Britain, France and Italy indicated that after the war they would no longer be prepared to grant MFN treatment to their German enemy, but would give trade preferences to each other. On the other hand, United States' President Wilson declared in his Fourteen Points Programme for the post-war period that all economic barriers should be removed (as far as possible) and that equality of trade conditions among all nations (which consent to the peace) should be established.<sup>21</sup>

Territorial changes in continental Europe resulted in nine new states and trading entities (in general, largely agricultural economies), which aimed to consolidate their newly-found independence and used tariff policy to foster their nascent industrial sectors. The division of Habsburg Austria into six independent states<sup>22</sup> led to the disintegration of one single market into six separate customs territories and a breakdown of the pre-war production pattern. Germany had lost provinces in the East, which previously supplied a large part of its grain output, and had been markets for its industrial goods. On its western border, Alsace and Lorraine, two important coal and steel producing regions, returned to France. Following civil war and revolution, Russia lost territory in the West and the Soviet Union became an inward-looking centrally-planned economy with a much reduced role for external trade in its economy. The territorial changes also provoked large displacements of people across Europe.

Despite the creation of the League of Nations in 1920, and the various international conferences sponsored by the League of Nations, the political willingness to cooperate internationally remained limited.<sup>23</sup> This was partly because the economic consequences of the war (in particular reparations, inter-allied war debts and unrealistic exchange rates) were not addressed properly. The United States, which had become the largest creditor and the strongest economy in the world, was reluctant to play an international role commensurate with its economic power, and was unwilling to join the League of Nations, whose creation it had sponsored. Domestically, the role of governments in economic affairs was greater after World War I than before it. This was partly due to the spread of more representative parliaments and a shift in public opinion, which expected governments to provide improved social protection and full employment.

However, the biggest and largely underestimated challenge was how to cope with the massive dislocation of production and trade patterns caused by the war. Before the outbreak of war, the major European countries traded extensively among themselves, and their overseas trade consisted largely of exporting manufactured

<sup>19</sup> The McKinley tariff of 1890 was partly reversed by the Wilson-Gorman Tariff Act of 1894. But the Dingley Act of 1897 'had the distinction of imposing the highest average rate of customs duties overall written into any US tariff law up to that time' (Dobson, 1976). The Payne Aldrich Tariff of 1909 changed little, while the Underwood Tariff Act of 1913 markedly reduced tariff rates (although these still remained high by European standards).

<sup>20</sup> According to Lewis (1981) nominal (and real) world merchandise trade growth was only marginally stronger in the 1860-80 period than in the subsequent 1880-1913 period.

<sup>21</sup> For a more detailed account of inter-war trade policy developments see Committee on Trade and Industry (1925), Frieden (2006), Kindleberger (1989), Irwin (1993), O'Rourke (2007), League of Nations (1942) and (1945), Liepmann (1938) and Rappard (1938).

<sup>22</sup> Austria, Czechoslovakia, Hungary, Poland, Romania and Yugoslavia.

<sup>23</sup> The major conferences were the 1922 Brussels International Financial Conference, the 1922 Genoa Conference, the 1927 Geneva World Economic Conference, and the 1933 London Monetary and Economic Conference.

goods and importing agricultural produce and other primary products. Trade among the European countries in manufactured goods had been increasing as the late-comers to industrialization caught up with the United Kingdom and started to overtake it in new fields (such as the chemical and electro-technical industry).

The war absorbed most of the domestic resources in the European countries involved in hostilities. This reduced exports, which were further curtailed by trade and transport restrictions, culminating in outright blockades enforced by military means. The breakdown of traditional trade flows reduced and reversed prevailing specialization in the world economy. For national security reasons, autarchy took hold in critical agricultural and raw materials sectors.

The self-destruction of Europe in World War I provided a massive stimulus for the economies outside Europe. Not only did export demand for raw materials and agricultural produce increase, but the decline in imports of manufactures from Europe also led to an expansion of manufacturing industry in regions outside Europe. Once the hostilities were over, a simple return to international pre-war production and trade patterns was not possible, given the existence of recently added capacity in agricultural output on a global level, which contributed to an abrupt price decline from the peak level reached in the period immediately after the war.

European governments and their people had great difficulty in accepting the wealth and income loss associated with the war, and had unrealistic expectations on how war reparations could offset their inter-allied debts and contribute to the reconstruction of their economies. The determination of realistic exchange rates remained extremely difficult as long as there was no certainty as to how the war debt should be paid, and how suppressed domestic inflation could be contained once numerous price controls were lifted. As these monetary issues were not properly addressed, hyperinflation and massive exchange rate adjustments occurred frequently in the two decades following World War I.<sup>24</sup>

### (i) *Tariff policies in the inter-war period*

The absence of any master plan after World War I and the lack of a coordinated international approach to dismantling war-time controls and facilitating the transition to an orderly post-war world economy created uncertainty and mistrust among nations, leading to political instability. The dire economic situation in most European countries and the fragile domestic political situation in many of them (especially in Germany, the major economy in Central Europe) combined with monetary instability made it very difficult for governments to accept lower trade barriers. On the contrary, given the shortages experienced during the war, many industries were considered strategically important and granted special protection after the war. Examples of this were parts of the chemical industry and electrical machinery industry in the United States and the United Kingdom (through the Fordney-McCumber Tariff in 1922 and the Safeguard of Industries Act in 1921, respectively).<sup>25</sup>

According to League of Nations calculations, tariffs on manufactured goods in 1925 were higher than before World War I in a majority of countries (Table 1). It may be noted that countries which had become creditor nations, in particular the United States (but also Argentina, Australia, Canada and India), increased or kept tariffs very high by international standards.<sup>26</sup> Another aspect of trade policy was the significant rise in preferential tariff margins in the Commonwealth countries.<sup>27</sup> In certain cases, the shift towards higher tariffs in the early 1920s compensated to some extent the lifting of various non-tariff barriers introduced during the war. The dismantling of war-time prohibitions, quantitative restrictions and exchange controls

<sup>24</sup> See Williams (1947) and Horowitz (2004).

<sup>25</sup> The United Kingdom prohibited the imports of dyes as dependence on German supplies of this product had been problematic during the war.

<sup>26</sup> According to a League of Nations estimate, the United States (together with Spain) had one of the highest overall tariff levels in 1925.

<sup>27</sup> Committee on Industry and Trade (1925: 24): 'The amounts of these preferences are in general substantial and they have increased materially since the war. ... At the present time this preferential advantage has on average increased to 9 percent *ad valorem*.'

was almost completely achieved by 1920 in North America, Belgium, Great Britain, the Netherlands, and the Scandinavian countries, but it took more time in other parts of Europe. In order to patch up the old trade and production linkages, Central Europe's trade was largely based on intergovernmental barter trade which was gradually replaced by a mixture of prohibitions and licensing systems.

**Table 1**  
**Applied tariff rates of major traders in 1913 and 1925**  
(Percentage)

	Manufactured goods		All products	
	1913	1925	1913	1925
Argentina	28	29	26	26
Australia	16	27	17	25
Austria-Hungary	18	-	18	-
Austria	(18)	16	(18)	12
Czechoslovakia	(18)	27	(18)	19
Hungary	(18)	27	(18)	23
Poland <sup>a</sup>	(13-18)	32	(12-18)	23
Belgium	9	15	6	8
Canada	26	23	18	16
Denmark	14	10	9	6
France	20	21	18	12
Germany <sup>b</sup>	13	20	12	12
India	4	16	4	14
Italy	18	22	17	17
Netherlands	4	6	3	4
Spain	41	41	33	44
Sweden	20	16	16	13
Switzerland	9	14	7	11
United Kingdom	-	5	-	4
United States	{ 44 25 <sup>c</sup>	37	{ 33 16 <sup>c</sup>	29

<sup>a</sup> Germany and Austria for 1913.

<sup>b</sup> Average of old and new tariff (from October 1925) for 1925.

<sup>c</sup> Referring to Underwood Tariff applied in 1914.

Note: Unweighted arithmetic average.

Source: League of Nations (1927) p.15.

By 1925-27, nearly a decade after the end of the hostilities, exchange rates had become more stable and world trade started to exceed the pre-war level of 1913, while the tendency to revise tariffs upwards almost came to a halt. However, it was not only high tariff levels but also the instability of tariffs that restricted international trade. In order to react quickly to currency changes, governments remained empowered to introduce surtaxes or apply "coefficients of increase". The number of bilateral trade treaties remained small up to 1925, and even when they started to increase, their duration remained short-term.<sup>28</sup> Rebuilding a more stable trading system would have implied a return to the MFN principle. Acceptance of a MFN clause in its unconditional form occurred in 1922 in the United States, but Europe, France and Spain resisted the application of the unconditional MFN clause until 1927/28. The generalization of the MFN clause over the course of the 1920s did not, however, extend to national treatment of foreign traders or firms. This meant that additional domestic charges or regulations could undermine the value of the tariff commitment, and do so in a discriminatory manner. In addition, non-

<sup>28</sup> According to Irwin (1993), the number of countries linked by commercial treaties rose from 30 in 1927 to 42 in 1928.

discrimination at the border was in many cases obstructed by means of very detailed tariff specifications which limited the applicability of bilaterally-agreed tariff reductions for third parties.

The temporary tariff truce of 1927-28 and the build-up of a network of commercial treaties based on an unconditional MFN clause started to fail when a sharp fall in agricultural prices occurred in 1928-29. France, Germany and Italy reacted quickly by raising their agricultural tariffs (Kindleberger, 1989:168). Tariff reform discussions in the United States Congress in 1929 focused first on higher agricultural protection but soon encompassed industrial products. In the end, Congress passed the Smoot–Hawley Tariff Act, which was signed by President Hoover and enacted in June 1930. During the debate over this tariff reform, 1,000 American economists and numerous countries protested against the tariff reform, but to no avail. Even before its implementation, this legislative act provoked widespread retaliation, contributing to a general increase in tariffs. The targeted increase of individual tariffs on goods of interest to the United States broke down any vestigial resistance to demands for protection.<sup>29</sup>

The passage of the Smoot-Hawley Act and the retaliatory response it engendered are considered a classic example of the disastrous repercussions of unilateral protectionist actions on international trade relations and the volume of trade flows. The protectionist measures introduced unilaterally by the strongest economy at that time, which was also the largest international creditor with a large trade surplus, did not produce the intended results. Domestic agricultural prices continued to decline and exports of agricultural produce and manufactures decreased. More importantly, Smoot-Hawley shattered the limited trust remaining in the trading system and wrought havoc on global trade flows.

Monetary policies played a more prominent role in the outbreak of the 1929 crisis, by accelerating the reversal of capital flows from Europe to the United States, and aggravated the deflation in Europe. Trade restrictions introduced in Europe in 1930 to limit the trade deficits and maintain debt payments contributed to the financial panic and bank failures in 1931, eventually leading the United Kingdom (on 21 September, 1931) and later the United States (on 20 April, 1933) to abandon the gold standard. Sixteen countries devalued or left the gold standard in the course of 1931.<sup>30</sup> The breakdown in international trade relations based on non-discriminatory bilateral trade treaties postponed economic recovery and had broader repercussions on international relations. Countries started looking for cooperation partners with whom they had or intended to develop special stable and preferential ties going beyond trade policy. Openly discriminatory trade relations evolved. This new direction of policy and the severity of the crisis led to the introduction of very blunt trade measures, including prohibitions, quantitative restrictions, exchange controls and clearing systems. Germany did not officially abandon the gold parity but introduced exchange controls (July 1931) and developed a multiple exchange-rate system. The autarkic reconstruction of the German economy under Hjalmar Schacht was accompanied by an elaborate system of preferential trade agreements with East European countries. Japan left the gold standard in September 1931 and strongly devalued the yen. Only a few months later its troops went to Manchuria to assure raw materials and energy supplies.

Having departed the gold standard in 1931, Britain participated in 1932 in the Ottawa Agreement, establishing the Imperial Preference System through a combination of a broad increase of general duties and substantial tariff preferences. Almost a century-old tradition of free, MFN-based trade policy ended when the United Kingdom surrendered its role as a stalwart of multilateral trade and the gold standard.<sup>31</sup> Discriminatory policies were widespread in other leading nations in favour of their colonies or of countries under their political influence. Much of this discrimination was caused by exchange allocation, clearing agreements and the administration of import quotas.

<sup>29</sup> Irwin (1998) provides estimates indicating that the Smoot-Hawley Act increased US tariffs on average by about 20 per cent and that the deflation up to 1932 increased the effective tariff rate by about 30 per cent. Liepmann (1938) provides estimates for the sharp increases in tariffs for 15 European countries between 1927 and 1931. According to one data set (Table 5) the average increase in applied European tariff amounted to 50 per cent between 1927 and 1931.

<sup>30</sup> Frieden (2006: 187); League of Nations, Statistical Yearbook of the League of Nations, 1939/40, Table 101 provides the dates when countries left the gold standard in the 1929-40 period.

<sup>31</sup> More precisely it was a period of 86 years (1846-1932) only interrupted by the World War I period.



The years 1932-33 witnessed perhaps the darkest period for trade policy in the twentieth century. In 1932, trade was at its lowest level in dollar terms since 1921. Between 1929 and 1932, trade measured in dollar terms contracted by 60 per cent and shrank in real terms by nearly one third (see Appendix Charts 1-4). Following the abandonment by the United States of the gold standard in early 1933, eight European countries forming the so-called “gold block” insisted at the London Monetary and Economic Conference (June 1933) on some dollar exchange-rate stabilization before considering a tariff agreement. However, United States President Roosevelt was unwilling to take any commitments in that direction “which rendered impossible any agreement on currency and thereby also on trade policy”.<sup>32</sup>

Once it became apparent that the Smoot-Hawley Act had failed to stem the agricultural crisis and did not lift prices of agricultural goods on world markets, nor improve domestic employment levels, United States’ policies began to take a new direction. The New Deal was introduced and on the trade policy front the Reciprocal Trade Agreements Act of 1934 was introduced. Given the domestic and international situation, the only feasible approach was to engage in bilateral trade negotiations. With the new trade act, Congress granted the President the authority to conclude reciprocal and mutually-beneficial trade agreements in which prevailing duties could be lowered by up to 50 per cent. Between 1934 and the end of 1939, 21 agreements with 19 countries were concluded, accounting for two-thirds of United States’ trade in the 1931-35 period (exports plus imports). The most important agreements were those with Canada (1936 and 1938) and the United Kingdom (1938). These countries had been by far the largest trading partners of the United States. Although the bilateral agreements took some time to put in place, they contributed significantly to the reduction of high protection levels prevailing in the mid-thirties.

The Reciprocal Trade Agreements Act of 1934 contained other important features. First, treaties were based on the MFN principle, so that all traders signing a treaty with the United States benefited from the tariff reductions agreed in all other agreements based on the Act. Second, detailed tariff setting was moved from Congress to the executive branch, thus diminishing the influence of narrowly-focused interest groups. The changed direction in United States’ trade policy in the 1930s came too late, however, to reverse the trend towards preferential trade areas.

As access to crucial raw materials from traditional overseas sources became less secure for a number of countries, national security concerns favoured tendencies towards regional bloc-building. This trend was ultimately wound up with the use of military force to secure access to critical sources of supply. Assured access to critical supplies were openly-declared war objectives of both Germany and Japan.

### (c) Conclusions

This brief historical summary emphasizes how easily the benefits of open trade can elude nations in the absence of a shared commitment to international cooperation. If countries submit to the temptations of protectionism, autarchy and narrowly-drawn nationalism, and these forces take hold, the trends are not easy to reverse before costly errors and attendant hardships have taken their toll.

A lesson from trade policy in the first half of the twentieth century is surely that effective and sustainable international cooperation must build on a predictable institutional framework that embodies a pre-commitment by governments to a certain policy stance. Nor should we forget that international economic policy is not only about trade protection – the treatment of international capital flows and exchange-rate policies also exert a strong influence on outcomes. Large shifts in international capital flows in a fixed exchange rate system (like the gold standard at the end of the 1920s) and uncoordinated (autonomous) large exchange-rate adjustments can undermine efforts to develop a predictable trade policy based solely on tariffs.

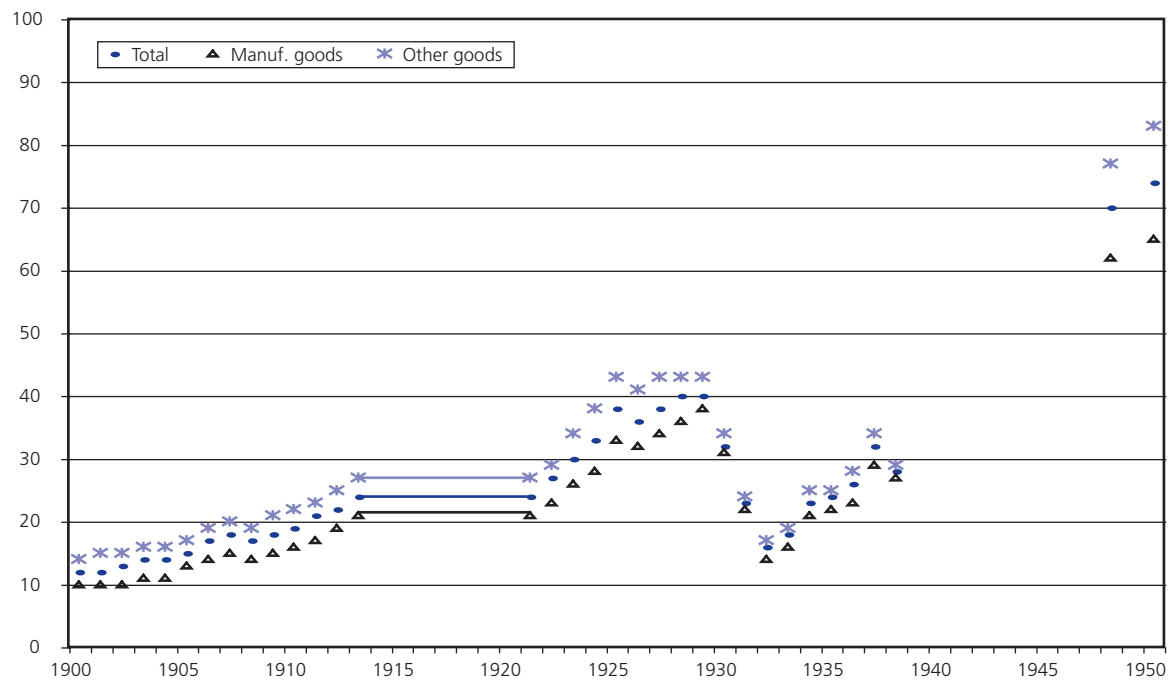
Leadership by a strong power can inspire engagement in building international cooperation, provided the exercise of such power is regarded as legitimate and enlightened by other nations – a role the United

<sup>32</sup> See Rappard (1938: 42).

Kingdom fulfilled to a degree in the nineteenth century. But strong leadership by large nations may not be sufficient for effective trade cooperation – smaller economies are often more open<sup>33</sup> and have a keener interest in this kind of cooperation than large economies. It is noteworthy that the smaller European countries (Benelux and Scandinavia) had much lower tariffs than the large continental countries in the first half of the twentieth century. Large economies less dependent on foreign trade might also be tempted to use trade policy as a foreign policy instrument in order to achieve non-economic objectives.

The high degree of world-wide economic integration achieved before World War I might have been more sustainable with better institutional foundations. The relative decline of the United Kingdom and the absence of a guiding institution created something of a void. This void was not filled by the United States prior to the Second World War, and the League of Nations proved too weak and unsupported to do the job. It may be argued that this was one of the lessons that the post-war institutional architects had learned, thus leading to the establishment of the Bretton Woods institutions and eventually, the multilateral trading system. If this is true, then what of the present situation with respect to international cooperation in the trade field? We are witnessing shifts in economic power among nations, and the multilateral trading system faces considerable uncertainty. In these circumstances, it is well to recall the lessons of the past, even if we accept that history does not repeat itself. What we have learned from six decades of international trade cooperation under the auspices of the multilateral trading system embodied in the GATT, and subsequently the WTO, and what challenges await the international community in the trade sphere, constitute the subject matter of the rest of this Report.

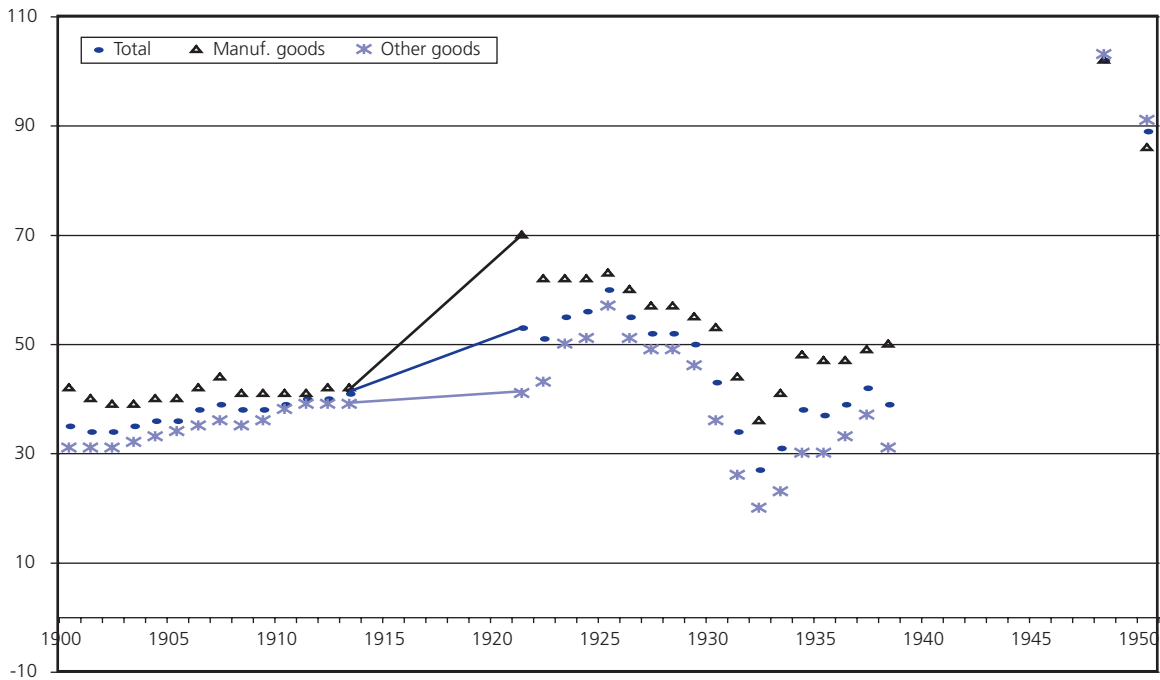
**Appendix Chart 1**  
**World merchandise exports, 1900-1950**  
(Indices, 1953=100)



Source: United Nations (1970) and Norbohm (1962).

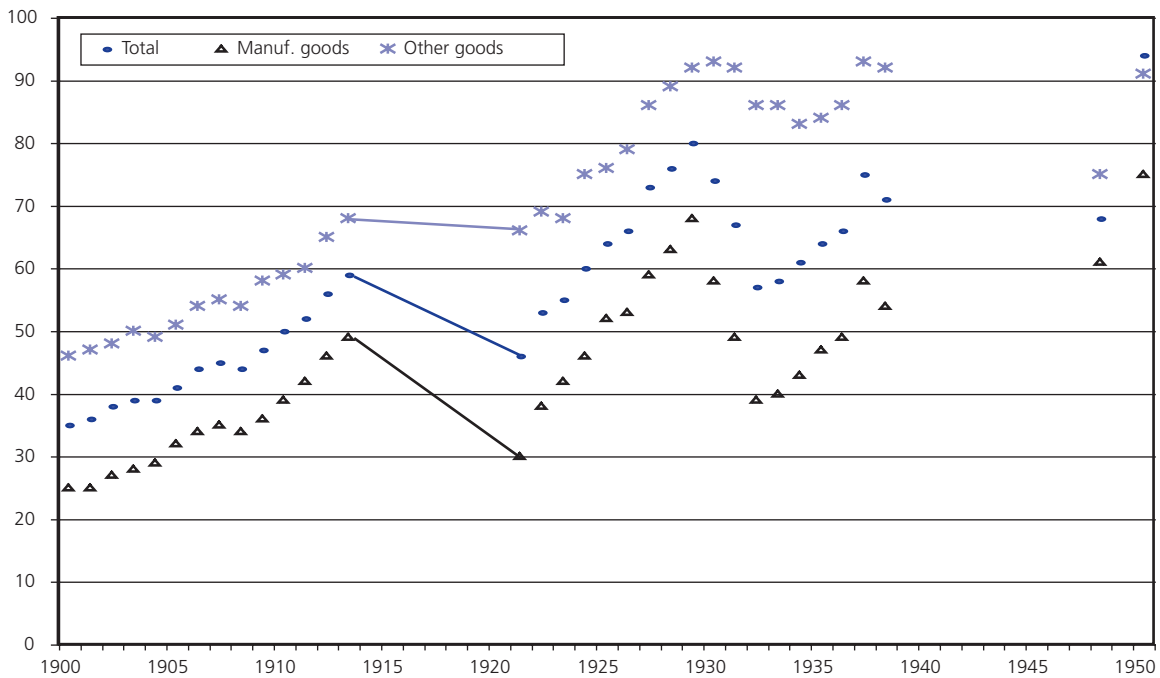
<sup>33</sup> This means 'open' in the technical sense of relying more heavily on trade as a component of overall economic activity.

Appendix Chart 2  
**World merchandise export prices, 1900-1950**  
 (Indices, 1953=100)



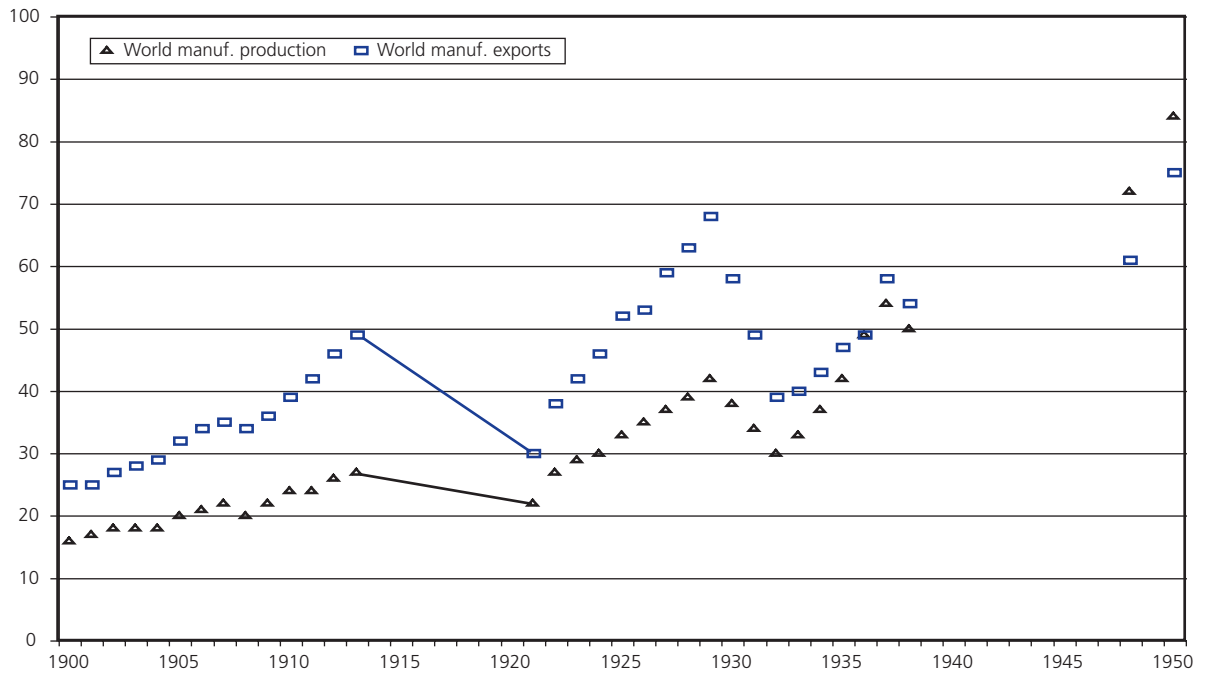
Source: United Nations (1970) and Norbohm (1962).

Appendix Chart 3  
**Volume growth of world merchandise exports, 1900-1950**  
 (Indices, 1953=100)



Source: United Nations (1970) and Norbohm (1962).

Appendix Chart 4  
**Volume growth of world exports of manufactures and of manufacturing output, 1900-1950**  
 (Indices, 1953=100)



Source: United Nations (1970) and Norbohm (1962).

**Appendix Table 1**  
**World merchandise exports by selected economy, 1870-1938**  
(Million dollars and percentage)

	1870	1900	1913	1921	1929	1932	1938
				Value			
World	5130	10100	19500	19700	33000	12700	22700
				Share			
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North America							
Canada	1.1	1.7	1.9	3.5	3.6	3.5	3.7
United States	7.9	14.1	12.8	22.4	15.8	12.5	13.5
South America							
Argentina	0.6	1.5	2.4	2.5	2.7	2.6	1.9
Brazil	1.5	1.8	1.6	1.1	1.4	1.4	1.3
Europe							
Austria	3.1	4.2	2.9	0.9	0.9	0.8	0.6
Belgium-Luxembourg	2.6	3.7	3.6	2.6	2.7	3.3	3.2
France	10.5	7.9	6.8	7.5	6.0	6.1	3.9
Germany	8.3	10.9	12.4	3.8	9.7	10.8	9.3
Italy	4.1	2.6	2.5	1.8	2.4	2.7	2.4
Sweden	0.8	1.0	1.1	1.3	1.5	1.4	2.0
Switzerland	...	1.6	1.4	1.6	1.2	1.2	1.3
United Kingdom	18.9	14.6	13.5	14.0	10.9	10.2	10.8
Russia/USSR <sup>a</sup>	4.2	3.7	4.0	...	1.3	1.7	1.1
Africa-Middle East							
South Africa	0.3	...	0.7	0.5	0.7	0.7	0.6
Asia-Oceania							
Australia-New Zealand	2.1	2.1	2.4	3.3	2.9	3.2	3.5
Australia	1.9	1.6	1.9	2.4	2.1	2.3	2.5
New Zealand	0.2	0.6	0.5	0.9	0.8	0.9	1.0
China <sup>a</sup>	2.0	1.2	1.5	...	2.2	1.6	1.9
India	5.0	3.4	4.1	3.1	3.5	2.8	2.6
Japan	0.3	1.0	1.6	3.1	2.9	2.9	3.3

<sup>a</sup> 1928 instead of 1929 and 1935 instead of 1932.

*Note:* Major breaks in time series affect continuity especially between 1913 and 1921 (e.g Habsburg Austria, Germany and Russia).

*Source:* Norbohm (1962) and Maddison (2001) Table F1 for year 1870.

**Appendix Table 2**  
**World merchandise imports by selected economy, 1870-1938**  
(Percentage)

	1870	1900	1913	1921	1929	1932	1938
	Share						
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North America							
Canada	1.5	1.7	3.2	3.2	3.6	2.8	2.2
United States	8.9	8.2	9.1	11.9	12.3	9.5	8.7
South America							
Argentina	...	1.0	2.4	2.5	2.3	1.5	1.8
Brazil	...	0.8	1.6	1.0	1.2	0.8	1.2
Europe							
Austria	3.1	3.3	3.4	1.6	1.3	1.3	1.1
Belgium-Luxembourg	3.1	4.0	4.4	3.5	2.7	3.2	3.1
France	9.7	8.5	8.0	7.8	6.3	8.2	5.7
Germany	...	12.8	12.7	5.7	8.8	7.9	8.7
Italy	3.3	3.1	3.5	3.4	3.1	3.0	2.4
Sweden	1.9	1.3	1.1	1.3	1.3	1.5	2.1
Switzerland	...	1.9	1.8	1.8	1.4	2.3	1.5
United Kingdom	22.1	21.4	16.1	17.5	15.0	16.2	17.1
Russia/USSR <sup>a</sup>	...	2.2	2.8	...	1.2	0.8	1.1
Africa-Middle East							
South Africa	...	...	1.0	1.0	1.1	1.1	2.0
Asia-Oceania							
Australia-New Zealand	...	2.1	2.2	3.4	2.4	1.7	2.9
Australia	...	1.7	1.7	0.7	0.6	1.1	2.0
New Zealand	...	0.5	0.5	0.7	0.6	0.6	0.9
China <sup>a</sup>	...	1.8	2.0	...	2.5	2.4	2.7
India	...	2.8	3.3	3.6	2.6	2.5	2.3
Japan	...	1.3	1.8	3.6	2.8	2.9	3.0

<sup>a</sup> 1928 instead of 1929 and 1935 instead of 1932 and for two years derived from partner statistics.

*Note:* Major breaks in time series affect continuity especially between 1913 and 1921 (e.g. Habsburg Austria, Germany and Russia).

*Source:* Norbohm (1962), Maddison (1962) and Maddison (2001) Table F1 for year 1870.

### Appendix Table 3

#### Ratio of merchandise exports to GDP, 1870-2005

(Percentage, real trade and GDP at 1990 prices and exchange rates)

	1870	1913	1929	1950	1973	1998	2000	2005
Canada	11.3	11.6	22.4	12.3	19.3	39.0	42.4	39.7
United States	2.5	3.7	5.9	3.0	4.9	10.1	10.6	10.2
Brazil	12.2	9.8	6.9	3.9	2.5	5.4	5.5	8.9
Mexico	3.9	9.1	14.3	3.0	1.9	10.7	12.3	12.3
Austria	5.5	8.6	7.4	5.2	16.3	45.5	52.7	64.8
Belgium	9.0	22.6	24.3	17.3	52.1	88.5	97.0	112.6
Denmark	8.3	12.8	23.2	12.1	23.7	41.9	45.5	49.4
Finland	15.5	25.0	40.4	18.7	30.2	51.6	54.6	51.9
France	4.9	7.8	11.5	7.6	15.2	28.7	29.9	27.6
Germany	9.5	16.1	14.8	5.0	20.6	38.9	42.1	51.1
Italy	4.3	4.8	5.9	3.5	12.5	26.1	28.7	28.8
Netherlands	17.4	17.3	29.7	12.2	40.7	61.2	62.9	77.7
Norway	9.0	14.0	23.3	12.9	26.2	55.4	56.7	55.6
Sweden	10.3	15.3	23.9	15.6	31.4	62.5	63.3	64.5
Switzerland	18.9	34.8	35.0	15.3	33.2	51.8	56.0	59.3
United Kingdom	12.2	17.5	14.2	11.3	14.0	25.0	23.1	19.3
Australia	7.1	12.3	13.2	8.8	11.0	18.1	19.8	18.6
China	0.7	1.7	2.6	2.6	1.6	4.9	5.9	10.7
India	2.6	4.6	4.0	2.5	2.0	2.4	2.9	3.7
Japan	0.2	2.4	6.1	2.2	7.7	13.4	14.6	15.7
World	4.6	7.9	9.0	5.5	10.5	17.2	18.5	20.5

Note: Territorial changes affect comparability in time for a number of countries especially between 1913 and 1929 and 1929 and 1950 (e.g. Austria, France, Germany, Great Britain, China, India and Japan).

Sources: Maddison (2001), *L'économie mondiale: une perspective millénaire*. Table F5 and WTO estimates for years 2000 and 2005.

## 2. THE ECONOMICS OF TRADE POLICY COOPERATION AMONG NATIONS

Economists traditionally distinguish three major approaches to the study of trade agreements, none of which is based on the familiar economic arguments for free trade. It would seem natural to attribute the impressive reduction in trade barriers achieved through multilateral or regional negotiations since World War II to the desire of governments to reap the benefits of free trade for consumers. There are, however, two problems with this reasoning. First, the economic case for free trade is a case for unilateral liberalization which does not leave any role for a trade agreement. Second, neither multilateral, nor regional liberalization have been driven by consumers. As pointed out by Bagwell and Staiger (2002), virtually every tariff that has been lowered by a government as a result of a GATT/WTO negotiation has been lowered because exporters somewhere in the world valued market access, and their governments were willing to offer access to their own market in exchange. This means that other ingredients than the economic arguments for free trade are needed to explain trade agreements.

The most elaborate economic approach to trade agreements, sometimes termed the “received theory”, addresses the possibility that countries with market power can manipulate the terms-of-trade<sup>34</sup> in their favour and at the expense of their trading partners. The second approach stresses the political economy of trade policies and the fact that governments care about the distributional effects of their interventions. The third approach stresses governments’ credibility problems *vis-à-vis* their domestic stakeholders. Each of the three approaches offers an explanation for the existence of international trade agreements. In the received theory, the agreement addresses an inefficiency that arises in a government’s relationship with other governments. In the commitment approach, agreements address inefficiencies that arise in the government’s relation with its private sector. With the political economy approaches the situation is less clear-cut, as a number of different perspectives may be embodied in the analysis. In some instances, agreements serve a similar purpose as in the terms-of-trade approach while in others they address inefficiencies that arise in a government’s relation with its private sector.

These approaches provide fairly general reasons why governments may enter into trade agreements with one other. Economists have identified more specific reasons why governments may cooperate in this manner and these will also be discussed below. The terms-of-trade argument is formalized in the literature and so are some political economy aspects. Other arguments are less formalized, but this does not necessarily mean they are any less relevant. None of the motivations analysed here should be regarded as mutually exclusive. On the contrary, efforts have been made to integrate various approaches within the same conceptual framework. As subsections 3 and 4 below will show, some overlap also exists between economic approaches, international relations approaches, and legal approaches to explaining the rationale of trade agreements.

### (a) Exchanging market access

#### (i) *The traditional approach*

The core logic of the terms-of-trade approach, often termed the traditional approach, can be summarized as follows. When nations set tariffs in an uncoordinated fashion, each government realises that its tariffs cause some damage to its domestic economy, but when part of the cost of the tariff is borne by foreigners, nations have an incentive to charge tariffs. When all nations do so, however, potential gains from trade are not realized. In such a setting, the switch from an uncoordinated tariff setting to coordinated tariff reduction can increase the size of the pie, so all nations can gain.

Participation in international trade agreements is not compulsory and within this framework of analysis, governments are assumed to enter into such agreements voluntarily. This means that agreements must allow all participants to reap some of the gains from trade. Note that with preferential agreements, such

<sup>34</sup> The terms-of-trade is a measure of the relative prices of a country’s imports and exports. If a country is able to lower the price of its imports relative to its exports, or raise the price of its exports relative to its imports, then it has secured an improvement in its terms of trade, or equivalently, an increase in national income.



benefits can at least in part be transferred from non-participants, a possibility that is discussed below. In the case of multilateral agreements, however, the participants' gains should not come at the expense of non-participants.<sup>35</sup> The multilateral trade agreement should generate mutual gains from trade that add to the size of the overall pie.

The traditional economic approach relates the inefficiency to terms-of-trade externalities between governments or, in other words, the fact that a country can improve its welfare as compared with free trade by imposing a trade barrier. This approach can be traced back to the mid-nineteenth century and the writings of Torrens (1844) and Mill (1844) on optimal tariffs and the role of terms-of-trade in their determination.<sup>36</sup> A seminal contribution is Johnson's paper (1953-1954) which formally shows how a national welfare maximizing government can use tariffs to manipulate its terms-of-trade – that is, the prices at which it trades, thereby generating inefficiencies that a trade agreement can correct. The traditional approach has been further developed in a number of contributions including the influential work of Bagwell and Staiger (1999, 2002).

The traditional approach has been developed both in game-theoretic terms and using a standard general equilibrium model of trade.<sup>37</sup> Here the argument is presented using a simple game-theoretic example that can be seen as an illustration of the Smoot-Hawley tariff war of the 1930s. Consider two large trading partners, A and B, facing two policy options. Each of them can either choose a free trade policy or impose a tariff that raises its own real income but reduces its trading partner's income. Assume also that governments can assign numerical values to the satisfaction they will derive from each policy outcome. Table 2 below shows the corresponding payoff matrix depending on whether or not the trading partners choose to cooperate. The first figure in each square is the payoff for country A, while the second is the payoff for country B.

**Table 2**  
**Trade war or trade cooperation?**

		B	
		Free trade	Protection
A	Free trade	10 \ 10	-10 \ 20
	Protection	20 \ -10	-5 \ -5

The payoffs in the matrix reflect the idea that each of the two countries can raise its welfare compared to the free trade position at the expense of its partner. This is an application of what economists call the terms-of-trade argument for a tariff. This argument, which plays a crucial role in the received theory, goes as follows. A country may apply a tariff to lower the price of its imports and thereby generate a terms-of-trade benefit. To do this, the country needs to be large enough to affect the prices of foreign exporters. When a large country imposes a tariff on imports of product X, it reduces world demand for this product sufficiently to depress its price on the world market. The large country thus obtains its imports of product X at a lower price. By analogy with a domestic tax that is partly paid by domestic producers, the tariff can be thought of as a tax on imported goods which is partly paid by foreign producers who cannot fully pass it on to domestic consumers and so end up bearing part of the burden.<sup>38</sup> Obviously, this "terms-of-trade" benefit must be set against the costs of the tariff, which arises because

<sup>35</sup> Multilateral does not mean universal, which means that there may be transfers from non-Members but that these transfers are not a prominent feature of multilateral agreements.

<sup>36</sup> See Irwin (1996).

<sup>37</sup> For an explanation of the terms-of-trade argument in formal game-theoretic terms, see Dixit (1987). For a formal presentation using a standard trade model, see Bagwell and Staiger (2002).

<sup>38</sup> This analogy also makes it clear why the terms-of-trade argument does not work for most NTBs. If there is no tariff revenue or equivalent rent accruing to a domestic agent, the optimal trade barrier is zero and the terms-of-trade argument cannot explain why nations agree to the liberalisation of NTBs.

of the distortion that the tariff introduces. It can be shown, however, that large countries can be better off with a tariff than with free trade. In short, the terms-of-trade case is an argument for using a strong market position to extract gains at a partner's expense.

Given those payoffs, each country is better off choosing to protect if it takes its partner's strategy as given. This captures the idea that countries, if they act unilaterally, end up in a trade war.<sup>39</sup> Predatory behaviour by one of the trading partners induces retaliation by the other. A "trade war" is a stable equilibrium (Nash equilibrium) as once protection is in place neither one nor the other country would have an incentive to reduce its tariff unilaterally. This is because it has no reason to expect the other to reciprocate and if the other does not reciprocate, the country that liberalizes is worse off. At the same time, however, both countries would be better off if they both chose free trade. This reflects the fact that one country's net terms-of-trade gain is less than the cost it imposes on its partner. Eliminating the tariffs on both sides thus yields a net gain for both countries.<sup>40</sup> All this means that if the two countries do not cooperate, they end up in the lower right corner of the matrix, whereas they would both be better off in the upper left corner. This situation is known as a prisoners' dilemma. Cooperation, in the form of a trade agreement, offers an escape from the prisoners' dilemma.

A trade agreement does not eliminate the beggar-thy-neighbour temptations of its signatories. This means that enforcement is a key issue. In order for the signatories' tariff reduction commitments to be credible, the agreement must be effectively enforceable. In the absence of other forms of punishment, this means that the short term gain of deviating from the commitment must be balanced by the long term loss from retaliation. Applying game theory, enforcement issues have been analysed using a repeated game setting with an infinite number of periods. A number of interesting insights can be drawn from this approach. First, the "most-cooperative" tariffs that can be achieved will depend on the enforcement constraint. The more they differ from the Nash equilibrium, the larger the incentive to cheat. Second, this perspective sheds an interesting light on the GATT/WTO dispute settlement procedures. They can be seen as an attempt to move from a non-cooperative equilibrium to a cooperative equilibrium by limiting the use of retaliation along the equilibrium path and repositioning it as a threat that serves to enforce the cooperative equilibrium. Dispute settlement and enforcement issues will be examined in more detail in Section C below.

The literature distinguishes between two approaches to trade negotiations. These approaches explain how governments can escape the prisoners' dilemma and move from the inefficient non-cooperative equilibrium to the political optimum. A power-based approach is one where governments bargain over tariffs without having previously agreed upon principles of negotiation. Under a rules-based approach, on the other hand, governments identify and agree upon certain principles by which subsequent negotiations must abide. The negotiations approach embodied in the GATT/WTO is of the latter type. Section C examines the specific rules by which Members must abide.

Under the traditional economic approach, the reason why governments can gain from trade policy cooperation is that they have the possibility of shifting costs onto each other, which leads them to pursue inefficient unilateral policies. The means through which the shifting of costs can occur is the terms-of-trade externality. Yet many economists are sceptical of the practical relevance of the terms-of-trade argument for trade agreements. The main reasons for this scepticism relate to: (a) the consistency of the main predictions of the terms-of-trade model with observed tariff patterns; (b) the consistency of the predictions of the model with the observed instruments of protection; (c) the consistency of the model's prediction with the characteristics of trade agreements; (d) the empirical relevance of the terms-of-trade theory; and, (e) the failure to explain both why small countries with no influence on world prices seek to form a trade agreement with one another, and why large countries may want to have a trade agreement with small countries.

<sup>39</sup> Technically, the outcome resulting from non-cooperative behaviour is known as a Nash equilibrium.

<sup>40</sup> A reduction in tariffs from the Nash equilibrium level is not sufficient to ensure mutual welfare gains. If there is sufficient asymmetry between the two countries, the largest country may be better off at the Nash equilibrium.

Bagwell and Staiger (2002) make considerable efforts in their book to convince their readers of the practical relevance of terms-of-trade considerations. First of all, they argue that presentation and interpretation matter. The traditional interpretation where the governments of large countries use a tariff to improve their terms-of-trade is too abstract and does not convince practitioners. They therefore present other interpretations which, in principle, should have more practical relevance in the eyes of policy makers. One such interpretation is in terms of market access and can be summarized as follows.

The inefficiency reflected in excess protection and too little market access – which trade agreements address – arises because foreign exporters' interests are not taken into account in domestic trade policy decisions. When country A imposes a tariff on imports from country B, it inflicts a cost on country B exporters in terms of lower prices. The inefficiency arises because A's government does not take this cost into account when setting its tariff. The role of cooperation is to provide a mechanism through which foreign exporters' interests are taken into account in governments' trade policy decisions so as to ensure that efficient levels of protection are chosen. Trade agreements then take the form of exchanges of market access for market access. If the agreement allows both countries to improve their welfare by offering new market access to their exporters without hurting any third party, then it can be said to be Pareto improving<sup>41</sup> from a global point of view. As pointed out by Staiger (2004), this interpretation of the purpose of trade agreements has two important implications. First, it explains why WTO Members are driven by exporters' interests in the negotiations without having to assume irrational mercantilist behaviour on their part. Second, with this interpretation, the argument in support of the WTO is far more general than the argument in favour of free trade.

Bagwell and Staiger (2002) also respond to various objections regarding the consistency of the main predictions of the terms-of-trade model with observed tariff patterns and other instruments of protection. The fact that some large countries do not set their tariffs at optimal levels is consistent with the terms-of-trade argument. These countries may simply form trade agreements to avoid being stuck with high optimal tariffs. Small countries that would be expected to have zero tariffs according to the terms-of-trade argument may have high tariffs on account of other (including political and strategic) motivations for setting tariffs. Other observed patterns can be explained only when certain refinements are added to the traditional model. For instance, the static version of the traditional approach does not account for the fact that liberalization is often introduced gradually. Bagwell and Staiger suggest, however, that when enforcement is modelled using a repeated game setting, and learning-by-doing (infant industry) effects are assumed to exist, an initial liberalization induces changes in the economy that enhance the value of cooperation and thus create the conditions for further liberalization. The basic model can also be extended to account for observed export subsidization programs and the use of voluntary export restraints (VERs).

The question of the empirical relevance of the terms-of-trade theory is probably the main objection to the approach. In effect, the evidence is mixed. The idea that countries set tariffs in response to their market power in international markets can be seen as the single most controversial result in international trade policy.<sup>42</sup> The trade war that resulted from the adoption of the Smoot-Hawley tariffs in the 1930s can be seen as an example of a non-cooperative Nash equilibrium. In fact, Whalley (1985) showed that the tariff rates that prevailed among major powers after the Smoot-Hawley Tariff Act were close to those that would be predicted in the Nash non-cooperative equilibrium for a computable general equilibrium model.<sup>43</sup> Bagwell and Staiger (2002) survey the limited amount of empirical work that is available and conclude that a "strong affirmative presumption" that governments are able to improve their terms-of-trade in a quantitatively significant fashion with their trade policy choices can be drawn from this work.<sup>44</sup> Interesting recent work tends to confirm this presumption. Broda et al. (2006) find evidence

<sup>41</sup> A 'Pareto improvement' refers to a change that yields a more efficient outcome than the status quo ante. More precisely a Pareto improvement occurs when at least one individual is made better off without making anyone worse off.

<sup>42</sup> See Broda et al. (2006).

<sup>43</sup> See Whalley (1985).

<sup>44</sup> See the survey in Chapter 11 of Bagwell and Staiger (2002) and the more recent studies by Bown (2004a, 2004b, and 2004c), Limão (2006) and Shirono (2003).

that countries that are not members of the World Trade Organization systematically set higher tariffs on goods with inelastic supply.<sup>45</sup> From this observation, they infer that countries are motivated by optimum tariff considerations. This result is robust to the inclusion of a political economy control variable.

Apart from this indirect evidence, there is very little direct evidence supporting the terms-of-trade interpretation of the role of the WTO. Along the same lines as the interpretation of the Smoot-Hawley tariffs, the multilateral trading system under GATT can be seen as representing an effort to move towards a cooperative equilibrium. Beyond this largely anecdotal evidence, only a recent paper by Bagwell and Staiger (2006) investigates empirically the idea that governments use trade agreements to escape from a terms-of-trade driven prisoners' dilemma. In this paper, a simple prediction is derived from the model and submitted to empirical tests. This prediction is that the difference between the non-cooperative tariff and negotiated tariff increases with the level of its non-cooperative import volume. The empirical strategy consists in regressing the difference between pre-accession and bound tariffs on pre-accession import levels for a sample of 16 Members that have acceded to the WTO under Article XII. The estimation results support the prediction and thereby the terms-of-trade theory.<sup>46</sup> However, in light of the limitations of their study, the authors conclude that it offers "a first, albeit promising, glimpse at the empirical content of the terms-of-trade theory of trade agreements."

The idea that a strong affirmative presumption in favour of the terms-of-trade approach can be drawn from existing work is challenged by Regan (2006). His interpretation of the Smoot-Hawley tariffs is that the story behind them is one of protectionism pure and simple. Based on detailed studies by political scientists of the politics and the legislative process that produced the tariffs, he argues that these tariffs, and more generally United States' tariffs in the last century, were not designed to maximise national income by collecting tariff revenue from foreign producers. Similarly, Regan argues that the Broda et al. (2006) correlations give no reason to think that there must be terms-of-trade manipulation in addition to a protectionist motivation. He also doubts that any result obtained using their sample of 15 countries that were not members of the WTO could be generalized. Regan also considers evidence from the rhetoric of trade policy, the general pattern of countries' trade policy behaviour, and the provisions of the WTO. His conclusion is that terms-of-trade manipulation is of very limited significance in the real world.

Regan (2006) argues that trade agreements are primarily about restraining protectionism, and he suggests that this is the view of most trade lawyers and economists. He acknowledges that there is no formal model of this theory and that it poses a number of puzzles. In particular, how can the same political forces first generate protectionism and then an agreement to restrain it? Regan suggests that the answer must be partly "framing effects" – people perceive their interests differently in different decisional contexts. He also argues that the reason behind the lack of a formal model of the anti-protectionism theory may be the difficulty of modelling framing effects.

Finally, an important limitation of the received theory concerns the relevance of the terms-of-trade argument in explaining the participation of small countries in trade agreements. This question is addressed in more detail in subsection 4 below, but a number of points are worth mentioning at this stage. The terms-of-trade approach provides a rationale for agreements between countries with market power, but for the most part fails to explain negotiations involving countries without market power. A crucial question is the extent to which developing countries are large enough in relevant markets to alter international prices with their policy choices. Based on theoretical work which suggests that even very small countries have the power to alter their terms of trade, Staiger (2006) argues that casual empiricism can be very misleading. It should be noted that systematic empirical evidence on this point is not yet available. To date, the evidence presented by Broda et al. (2006) probably represents the most important contribution in this area.<sup>47</sup> The traditional approach, however, is not the only possible explanation for the

<sup>45</sup> That is, goods whose supply is relatively unresponsive to price changes.

<sup>46</sup> The results also provide some support for the commitment approach (see below).

<sup>47</sup> Evidence presented in this paper suggests that a group of 15 developing countries which were not Members of the WTO were motivated by optimum tariff considerations when they set their tariffs.

participation of small countries in trade agreements. As discussed below, political economy approaches provide further explanations.

*(ii) The political economy approach: triggering the support of exporters*

The terms-of-trade driven prisoners' dilemma discussed above offers a powerful explanation of the role that international trade agreements can play. But, traditional models assume that governments are immune from political pressure and act as benevolent servants of the public interest. What is the role of international cooperation when governments are not only concerned with improving the standard of living of their electorate, but also with collecting campaign contributions from special interests groups? This question is addressed by political economy models of trade.

Political economy models of trade view individuals and firms as *demandeurs* of particular trade policies, such as import protection, and governments as the suppliers of these policies. Governments care about the political as well as the efficiency consequences of trade policies. In particular, in this set-up governments are seen as aiming to maximize national welfare subject to the political constraints under which governments operate, which is that of being re-elected. Therefore, governments respond to the demand of individuals and firms who provide the votes and the funds for their election. In other words, governments choose trade policies so as to maximize a weighted sum of the contributions offered by individuals and firms and their likelihood of being re-elected. The former will depend on how much of the private benefits from the political process special interest groups will be able to capture. The latter will depend on whether the income of the median voter will increase. According to these models, tariffs are chosen to balance the demand and supply of protection in the political market, much as prices balance demand and supply in the goods markets.

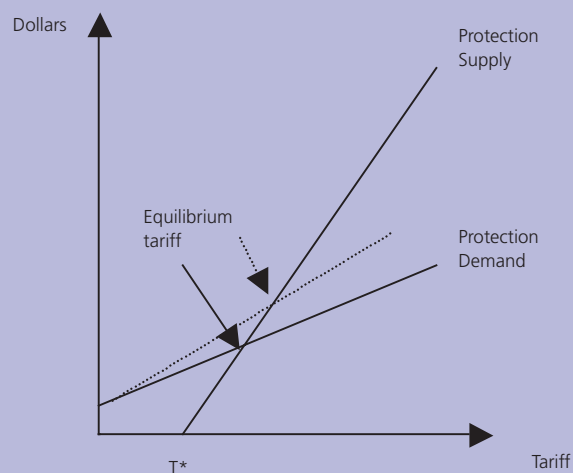
When governments chose their trade policy unilaterally, an equilibrium will emerge where there are two reasons why a government will wish to tax international trade: the political support and the terms-of-trade motive (see Box 1 for a more analytical treatment of how tariffs are set in a political economy model).

**Box 1: Unilateral tariff setting in a political economy model**

The distinguishing feature of political economy models is that governments shape their trade policy not only in pursuit of economic efficiency, but they also care about the political consequences (i.e. distributional effects) of their tariff selection. Two main approaches may be distinguished in the political economy literature. One stresses the competition between opposing parties during the election (see Magee et al., 1989; and Hillman and Ursprung, 1988). In this setting, candidates commit to different policies before the elections. Lobby groups contribute to the election campaign of the candidate that commits to the policy that makes them better off. Then, candidates use these contributions to shift votes in their favour. Political contributions are clearly motivated by a willingness to influence the elections, and the value of the contributions will depend on the benefits that lobby groups will derive from the election of their favourite candidate.

The second approach focuses on the policy choices of an incumbent government that attempts to maximize its likelihood of being re-elected, but in this set-up, unlike in the previous one, the election process is not explicitly modelled. Two classes of models use this approach: (i) median voter models, which assume that policies are established by majority vote (Mayer, 1984); and (ii) lobby models, where policies are determined not only on the basis of consumers' welfare but are also influenced by contributions by lobbying groups (see Baldwin, 1987; and Grossman and Helpman, 1994).

According to a basic lobbying model of tariff choice, governments set tariffs such that the supply of protection equals the demand for protection in the political market. Graphically, the supply of protection will be defined by how much a government will be willing to supply if it receives a contribution equal to  $y$ . This curve will be positively sloped, and, for a large country, will be equal to the optimal tariff for a contribution equal to zero (in the chart below this is the positively-sloped curve denoted “protection supply”, that intersects the horizontal axis at the level of the optimal tariff  $T^*$ ). The demand for protection can be represented by a positively sloped curve that defines how much a firm is willing to offer for a marginal increase in tariff (in the chart this is the line called “protection demand”). The curve is positively sloped because a marginal increase in tariff will increase the firm’s operating profits. The chart below represents the equilibrium in the political market. This is defined by the point where the demand curve crosses the protection curve. The chart shows that the equilibrium tariff will be higher than the optimal tariff. The optimal tariff will respond to the terms-of-trade motivation for setting a tariff and the rest is the politically motivated tariff.



Source: Baldwin (2006)

The political optimum tariff will depend on the size of the import-competing sector. If this is large, the equilibrium tariff will be higher. This is because the higher the number of firms in the import-competing sector, the stronger the impact of a hike of protection on the import-competing profits will be for any given level of tariff. Graphically, the demand for protection will rotate inwards (the dashed line in the chart). Therefore, the equilibrium tariff will increase.

Some empirical evidence supports the assumptions of the political economy models.<sup>48</sup> For example, legislators tend to vote in a protectionist manner the higher the proportion of voters in their district who are employed in import-sensitive sectors (Baldwin, 1996). Furthermore, certain empirical evidence supports some of the conclusions of the political economy models.<sup>49</sup> For example, several studies provide evidence of a positive relationship between levels of protection and the extent to which an industry is politically organized.

As may be expected, in these circumstances the economic incentive for governments to manipulate the terms-of-trade creates an inefficiency that a trade agreement can solve – just as in the case when governments are only concerned with national welfare and are not affected by lobby pressures. As Bagwell and Staiger (2002) point out, political economy models do not provide a new reason for trade

<sup>48</sup> For evidence on the political economy approach see Magelby and Nelson (1990), Snyder (1990), Baldwin (1985), Tosini and Tower (1987), Riedel (1977), Lavergne (1983), Trefler (1993).

<sup>49</sup> See Goldberg and Maggi (1999); Gawande and Bandyopadhyay (2000); Mitra et al. (2002); and MacCallum (2004).

agreements to exist – even politically-motivated governments engage in trade agreements only to correct for terms-of-trade externalities. The contribution of political economy models to the understanding of the existence of a trade agreement is that they explain the motivation for governments to eliminate the incentive to manipulate terms-of-trade by the interaction of private interest groups and political-support-seeking governments. In this set up, the terms-of-trade motive for taxing international trade imposes a cost in terms of median voter welfare, since tariffs imply higher prices for consumers. Governments know that freer trade would be better for their nation, but they also know that an attempt to reduce tariffs unilaterally will encounter opposition from the import-competing sector.<sup>50</sup> In other words, the unilateral reduction of tariffs is not politically viable because even if it would benefit a large number of consumers and only hurt a small number of producers, the latter are much better organized to press their case than the former. Yet governments realize that they may spare each other political costs by cooperating. This is because by entering a trade agreement, whereby tariffs are reduced reciprocally, they may help each other foster the political support needed to implement a freer trade policy.<sup>51</sup>

In the political economy approach, as in the traditional approach, the principle of reciprocity provides a way to eliminate the incentive to manipulate the terms-of-trade. Reciprocity is the key because it will convert each nation's exporters from bystanders in the tariff debate to opponents of protection within their own nation.<sup>52</sup> When liberalization is reciprocal, exporters can gain from better access to foreign markets only if tariffs in their own country are lowered. This will trigger the support of domestic exporters in favour of trade liberalization policies. Since foreign tariffs are a function of domestic tariffs under reciprocity, contributions by lobbies will depend on both domestic and foreign tariffs. Therefore, all countries find it optimal to cut tariffs (Grossman and Helpman, 1994 and 1995a, and Baldwin and Robert-Nicoud, 2006). In particular, tariffs that reflect both terms-of-trade and political economy motivations will be reduced by the amount that is attributable to the terms-of-trade motive. The politically optimal tariff will remain in place.

Political economy models can provide an explanation for a number of empirical observations. These include the observations that: (i) the process of liberalization has been gradual;<sup>53</sup> (ii) much liberalization has taken place in products where two-way trade is prevalent (Baldwin, 2006); and; (iii) trade agreements generally do not prohibit terms-of-trade manipulation through export-taxes. It is important, however, to underline that political economy considerations are neither the only possible explanation for these facts, nor do they solve all puzzles.

As mentioned above, a dynamic version of the traditional model could explain why the liberalization process has been gradual.<sup>54</sup> However gradualism can also be explained with political economy models. Lobbying pressures will depend on the size of the import and export sector. The larger the number of firms in a sector the stronger the pressure. When a government announces reciprocal liberalization, the domestic tariff will decrease. This, in turn, will reduce the number of firms in the import-competing sector and increase the number of exporting firms. Therefore, this initial liberalization will trigger pressure for further liberalization by the export sector. The process will gradually lead to free trade. This process is known as the "juggernaut effect" (Baldwin, 1994; Baldwin and Baldwin, 1996; for a formal treatment, see Baldwin and Robert-Nicoud, 2005).

<sup>50</sup> Notice that free trade is not domestically optimal in political economy models because of the political support motive for a tariff. Yet a reduction of tariffs to eliminate the terms-of-trade motivated part of the tariff is optimal.

<sup>51</sup> Bagwell and Staiger (2002) stress that benefits occurring to exporters are also important to governments that maximise national welfare under the traditional approach. That is, the standard political economy interpretation of reciprocity – that reciprocity mobilizes political support which serves as a counterweight against protests by import-competing firms – is in fact already embedded in the terms-of-trade model.

<sup>52</sup> See Baldwin (2006).

<sup>53</sup> By gradual we do not mean there is a phase-in implementation period, but rather that multilateral liberalization has been achieved through a series of successive rounds of liberalization.

<sup>54</sup> See Bagwell and Staiger (2002, Chapter 6) for a review.

The juggernaut effect, as formulated above, explains the process of gradual liberalization in situations where the import-competing firms and exporting firms produce different goods. Therefore, it explains trade liberalization in import-competing sectors. But most post-war liberalization has taken place in sectors characterized by intra-industry trade. When applied to new trade theories built around the existence of heterogeneous firms within and among industries (Melitz, 2003; and Eaton and Kortum, 2002), political economy models of trade can also explain trade liberalization in industries characterized by two-way trade. In these models, countries trade different varieties of the same good (i.e. trade is intra-industry in nature). Furthermore, firms differ in size and efficiency, and there are fixed costs of entry in a foreign market. Because of these so-called beachhead costs, only the largest, most efficient firms export in each sector, while smaller firms only sell domestically. When countries enter a trade agreement, reciprocal trade liberalization will raise the profits of big export firms while lowering the profits of small firms in the same industry that sell only in the local market (Falvey et al., 2004, Baldwin and Forslid, 2004).<sup>55</sup> In terms of political economy pressures, this implies that intra-sectoral special-interest groups will emerge – large firms will lobby in favour of liberalization, while small firms will lobby against. But big firms will be better organized politically than small firms in the same sectors. Overall, sectors characterized by intra-industry trade will be pro-liberalization. Over time, liberalization will beget further liberalization, as small firms will become smaller and perhaps exit the industry, resulting in relatively more support for further liberalization (Baldwin, 2006).

Regarding the third point above, the political economy approach to trade agreements, it has been claimed, solves the so-called terms-of-trade puzzle in the traditional theory (Ethier, 2006). The puzzle is reflected in two observations: (i) actual trade agreements do not prevent countries from manipulating their terms-of-trade with export taxes;<sup>56</sup> and (ii) industrial countries nevertheless do not by and large implement such taxes. Indeed, political economy models of trade predict that if the interests of owners of factors specific to export sectors are sufficiently important, governments will not wish to tax exports.

However, as has been argued by Bagwell and Staiger in a number of their works (Bagwell and Staiger, 2002, Chapter 10; Bagwell and Staiger, 2001 and Bagwell, 2007) the argument above has two weaknesses. First, Ethier's criticism applies with less force in a world of many goods than in a simple two-good model. Second, the political economy approach to the terms-of-trade argument for a trade agreement opens up another puzzle: that of the restrictions on export subsidies. The argument is the following. A politically motivated government, while it may not be tempted by export taxes, would under-supply export subsidies. This is because export subsidies generate terms-of-trade gains to the importing country that the exporting country would not take into account when setting trade policy unilaterally. The question then arises as to why the WTO Agreement, for example, has restrictive rules on the use of export subsidies.

### (b) Capturing credit for the benefits of trade liberalization

Economists have also explored the idea that inter-governmental political externalities give rise to trade agreements. This alternative approach, however, remains highly controversial, in part because of the limitations and weaknesses of the theoretical models developed so far.<sup>57</sup>

In Ethier (2004), the government does not obtain all the political credit from the benefits of unilateral trade liberalization because exporters are imperfectly informed. Special interests are subject to "bounded rationality" – that is, their political support is more sensitive to the "direct effects" of government actions than to the "indirect consequences". For example, if country A reduces textile import tariffs and

<sup>55</sup> The intuition is simple. Reciprocal liberalization harms small firms that sell only locally since it raises the degree of competition they face; they have no exports to benefit from the expanded foreign market access. For the big firms, by contrast, the extra competition at home is offset by better market access abroad. On net they gain since their sales benefit from the downsizing and exit of small firms in both markets.

<sup>56</sup> For example, nothing in the GATT/WTO prevents a country from introducing export taxes.

<sup>57</sup> Ethier (2004 and 2006) present models of political externality driven trade agreements. For a discussion of this approach see Bagwell and Staiger (2002).



subsequently textile imports rise, the import-competing textile industries will realize that the government is responsible for this and will oppose liberalization. In contrast, although more textile imports might boost exports of textile machinery to the foreign supplying country enjoying additional textile exports, domestic exporters in the textile machinery industry will most likely give only partial credit for this to the government. Therefore, they will only provide minor support to the liberalization policy. Because of this imperfect information, a free trade policy, although optimal, cannot be implemented because it is not politically viable.

Entering a trade agreement may help governments to foster the political support needed to implement a freer trade policy. This is because each government will enable its partners to capture a larger share of the credit for the benefits of the agreement by furnishing signals (in the form of “concessions”) that the agreement has indeed generated those benefits. Continuing with the example above, if country A negotiates better market access for textiles machinery in country B, it will get the credit for the increased exports of this sector. Greater support from exporters will allow the government to proceed with trade liberalization.

In conclusion, reciprocal liberalization triggers the support of exporters in both the international political externality theory for a trade agreement (discussed here) and the political economy variant of the terms-of-trade argument (discussed in the previous subsection). The crucial difference between these two approaches is that while exporters in the former case do not give due credits to the government for the benefits from unilateral liberalization, in the latter case exporters gain more from reciprocal liberalization than from unilateral liberalization. The difference is crucial, as it may potentially provide an explanation of trade agreements among countries without market power.

### (c) Increasing credibility

Another reason for countries to join an international trade agreement is to solve time-inconsistency problems. In this case, the source of the problem is a domestic inefficiency, resulting from the interaction between a government and its own private sector. Time-inconsistency problems can arise when the decision of the government to implement a certain policy at some future time is not optimal when the future period arrives.<sup>58</sup> Therefore, the announcement that a certain policy will be implemented at a later time is not credible. The inconsistency is primarily about commitment and credible threats. One example of time inconsistency for trade policy is provided by Matsuyama (1990).<sup>59</sup> Suppose that country A has developed a certain large and inefficient industrial sector behind high tariff barriers. Suppose as well that the government of country A realizes that at present the costs of maintaining such a large and inefficient sector are too high and, therefore, announces that at a future date it will open up the sector to international competition. If the announcement is credible, the industry will decide to restructure and invest in cost-saving technologies. At the pre-announced date, the government will liberalize the sector. A problem of time inconsistency may arise if the industry foresees that the government will not liberalize if the sector is not ready for international competition. In this case, following the announcement of trade liberalization, the industry will not undertake the required restructuring. At the stage of policy implementation, the government will not liberalize because if it did, it would have to face the costs of a crisis in the sector. The government is trapped in a situation in which it cannot credibly liberalize.

By “tying the hands” of a government, an international trade agreement may help to make credible policy commitments affecting the private sector that it would not be able to maintain without the agreement. The commitment to an international agreement will signal to domestic actors that if the

<sup>58</sup> The problem of time inconsistency was first highlighted with regard to monetary policy. In their seminal paper, Kydland and Prescott (1977) show that the discretion of the central bank to revisit a certain policy after its announcement can create a time inconsistency problem that makes the economy worse off.

<sup>59</sup> Other papers focusing on credibility issues in trade policy and not discussed in this section include: Carmichael (1987), Staiger and Tabellini (1987, 1989, 1999), Gruenspecht (1988), Lapan (1988), Maskin and Newberry (1990), Tornell (1991), Brainard (1994), Mayer (1994), McLaren (1997, 2002), Grossman and Maggi (1998), Krishna and Mitra (2005) and Mitra (1999).

government reneges on its commitment it will face additional external costs, such as retaliation from a trading partner. This external threat makes the policy announcement credible, and solves the time-inconsistency problem, thus making trade liberalization viable.

Typically, the time-inconsistency problem is purely economic in nature. But time inconsistency is also a reason for international cooperation in the context of political economy models. In this context, trade agreements provide a way for the government to foreclose the political pressure of domestic special interest groups that may be lobbying for protection.<sup>60</sup> At first sight, this argument may appear in contradiction with political economy models that stress the role of lobbies in influencing the policy of a government. Why would a government want to commit to a trade agreement and distance itself from lobby groups if it receives electoral contributions from them?

Maggi and Rodriguez-Clare (1998) describe three situations in which this can be the case. In all three situations a government seeks to minimize distortions in the present that may arise in the future. One case is when a government may be subject to lobbying pressures by a politically organized import-competing sector. If the country does not have (nor may develop over time) comparative advantage in the sector, the protection will distort investment and lead to an oversized sector. This may be better than free trade for the government in the short-run (as contributions may compensate social welfare losses), but in the long-run the costs of distortions will be too large. The government may therefore seek to enter into a predefined trade agreement to minimize these distortions from the beginning.

An example of a second situation in which a government may prefer to commit to a trade agreement is when the adjustment process is slowed down because a declining sector relying on government protection is hit by a terms-of-trade shock. Again, the costs of the distortion due to the misallocation of resources may be too high in the long run. Therefore, the government may seek a commitment through a trade agreement to avoid delay in the adjustment process in the declining sector.

Finally, a third situation is one where an inefficient firm with the potential to develop strong lobbying power may over-invest in order to seek future protection from the government. By committing to an existing agreement, a government will seek to avoid such long-term distortionary investments.

The commitment argument is closely linked to two popular propositions that are often used in discussions of the benefits of accession to the WTO or in relation to the enlargement of the European Union. The first argument is the idea that accession to the WTO or to the EU can play the role of an “external anchor”.<sup>61</sup> This notion, which originates from the macroeconomics literature, captures the idea that by establishing a substantial number of policy goals and conditions on which consensus might be difficult to reach, “external anchors” such as the WTO or the EU help focus policy, thereby functioning as an arbitration mechanism in case of differing internal political opinions. The second argument corresponds to the idea that signing a trade agreement can be used as a signalling device. It has been argued, for instance, that WTO membership has provided a potent symbol of China’s continuing “opening up” to the rest of the world. Because, to the best of our knowledge, these arguments have not been formalized, it is difficult to assess exactly how they operate.

A number of arguments have been raised by economists that point to the irrelevance of the commitment interpretation for joining a trade agreement. One argument is that the commitment approach relies on enforceability, but this may not be effective. For example, the incentive to enforce WTO rules in small and poor developing countries may be too weak for such countries to benefit in domestic political terms from international commitments. An essential element for a trade agreement to play a commitment role is that its rules are enforceable and that there is a credible threat associated with non-compliance with those rules. In the WTO this is accomplished with the threat of retaliatory actions and enforcement is provided

<sup>60</sup> The case of “political” time inconsistency is different. In this case, the government does not lack credibility and there is not a time inconsistency problem. Nevertheless, a government may wish to lock in its policy to diminish the likelihood that a future government may reverse the policy.

<sup>61</sup> See IMF (2000) World Economic Outlook, October 2000, Chapter III, Transition: Experience and policy issues.

through the dispute settlement system.<sup>62</sup> However, there is a limited incentive to engage in a dispute with a small low-income country if the costs of the procedure offset the gains of a positive outcome. In the absence of a credible threat, there is little scope for the WTO to serve as a commitment device for small and poor countries.

Secondly, some design features of trade agreements cannot be explained on the basis of the commitment approach. For example, the WTO safeguard (escape clause) provisions “work against the role of WTO in serving as commitment mechanism to constrain the actions of governments against their private sector” (Staiger, 2004).

A third argument is that governments, at least governments with a high reputation, can in principle find solutions other than an international trade agreement to solve a potential commitment problem. They could, for example, establish an independent institution to deal with trade policy.

Very little empirical evidence exists on the possible commitment role played by international trade agreements. But available evidence provides some support for the commitment theory. A paper by Staiger and Tabellini (1999) supports the view that the GATT has worked as a commitment device. In particular, they investigate whether GATT rules allowed the United States government to make credible commitments to its private sector. To test this, they compare the decisions of the United States government on whether or not to give protection to an industry in two different circumstances: (i) during the Tokyo Round negotiations, when each country could choose to exclude certain product categories from the general tariff-cutting rule and specify an alternative tariff change for these products; and (ii) following the completion of the Tokyo Round, when each country could temporarily increase tariffs on a unilateral basis if the conditions for escape clause action were satisfied. The crucial difference between these two environments is that only in the former do GATT rules serve as a potential commitment device. In contrast, once the injury condition that activates the escape clause is established, a government is free to adjust its tariffs. A government that cannot credibly commit to a trade policy would not take production distortions into account when selecting an exclusion from the tariff-cutting formula. But if the GATT works as a commitment device it should help a government to make decisions that would minimize production distortions. Consistent with expectations, Staiger and Tabellini (1999) find that the United States government granted fewer departures from the tariff-cutting formula in sectors where an exclusion induced higher production distortions, whilst they find a positive association between escape clause protection and induced production distortions. This is what should be expected if the escape clause offers a government that lacks credibility in the absence of international rules an opportunity to undo what the rules have accomplished.

More recently, Bagwell and Staiger (2006) attempted to investigate empirically the purpose served by market access commitments in the WTO. Although their findings mainly support the view that trade agreements are useful to governments to escape the terms-of-trade prisoners’ dilemma, they seem to suggest a possible commitment role of the WTO as well.

Finally, Eschenbach and Hoekman (2006) investigated the role that GATS and EU commitments have played in affecting the service sector reforms in 16 transition economies. Their findings appear to suggest that the WTO played a weak commitment role, although the EU itself may have worked as an effective commitment device. Results differ across countries – for most EU-acceding countries GATS commitments have not been relevant, as their policy reforms can be explained by requirements linked to their accession to the EU. For the non-acceding transition economies, GATS commitments appear to have contributed little to policy reform in services. Furthermore, no case has been brought to the WTO against any of these countries.

To conclude, it is worth highlighting that the terms-of-trade approach and the commitment approach are not mutually exclusive. In a recent paper, Maggi and Rodriguez-Clare (2007) combine these two approaches into one framework. In this setting, if governments do not cooperate two types of inefficiency

<sup>62</sup> See subsection 4 below.

emerge – a domestic time-inconsistency problem and a prisoners’ dilemma arising from the terms-of-trade externality. The model presents a number of interesting implications. Most importantly, it explains why trade agreements typically specify tariff ceilings rather than exact tariff levels. The intuition for this result is that the commitment to a tariff ceiling keeps the lobbying game alive. Lobbies will be obliged to pay contributions ex-post, and this will reduce returns to capital and in turn help to reduce the distortions caused by lobbying itself.

#### (d) Other motives for cooperation among nations

The arguments we have examined in the previous sections (relating to the terms-of-trade externality, the politics of trade liberalization, and policy credibility) explain why countries may set higher tariffs in the absence of cooperation and why there is a case for reducing these tariffs through international cooperation. The economic rationale for cooperation relates to an economic inefficiency that a trade agreement can solve. Furthermore, it is important to note that all these arguments are valid for multilateral trade agreements as well as bilateral or regional trade agreements.

Several other economic reasons exist why countries may want to cooperate on trade policy. These include increasing market size, ensuring against preference erosion, enhancing protection, or increasing bargaining power. Most of these arguments are relevant in the context of preferential arrangements, implying that some of the benefits from the trade agreement may come at the expenses of non-participants. But some of the arguments also motivate the case for participating in the multilateral trading system.

##### (i) *Increasing market size*

Countries may want to cooperate on trade issues in order to increase their market size. The argument is especially valid for small countries. Smallness will be a disadvantage if markets are not large enough to generate the sales volume necessary to cover costs. Access to foreign markets would allow domestic firms to exploit economies of scale and produce at lower costs.

Increasing market size can be a motivation for multilateral or regional cooperation. In the case of a regional arrangement, the opportunity to exploit economies of scale may provide firms with a competitive edge relative to firms producing the same or a similar good located in other small countries outside the regional trade agreement. In addition, preferential access to a large market may prove particularly advantageous in increasing a country’s attractiveness to foreign direct investment.

Since access to the market of a small country is unlikely to be an essential motive for trade cooperation from the point of view of a large country, the latter will be motivated to cooperate only if issues other than tariffs are on the negotiating agenda. This helps to explain why small countries might make concessions on issues such as standards, government procurement or intellectual property rights, which they may otherwise regard as uninteresting from a national welfare perspective..

##### (ii) *Insurance motive*

Countries may also cooperate on trade policy to insure themselves against the erosion of market access in a large market. The insurance motive may best be explained against a backdrop where many small (developing countries) are establishing free-trade agreements (FTAs) with larger (developed) country partners.<sup>63</sup> These hub-and-spoke arrangements are a prominent feature of the current Regional Trade Agreement (RTA) landscape. In this environment, forming a RTA with a large country partner is an insurance policy against the erosion of market access to the large market. This may also help explain

<sup>63</sup> Empirical support for this third-party terms-of-trade externalities is offered in Chang and Winters (2001), Bown and Crowley (2006 and 2007).

why small countries are willing to give significant concessions to enter such RTAs. One can think of those concessions as a form of insurance premium that is paid to guarantee or preserve access.<sup>64</sup>

However, the insurance motive can also be seen as a reason for cooperation at the multilateral level. Those developing countries that are excluded from a RTA with a developed country – or face less favourable market access conditions – may choose to push toward multilateral liberalization in order to re-create a level playing field among developing countries in terms of their access to the markets of developed countries.

### *(iii) Protectionism*

A trade agreement can also serve a protectionist rationale. This can be a motive for a bilateral or a regional trade agreement, but not for a multilateral agreement where concessions have to be extended on a MFN basis. The theoretical argument for this is made in the political economy literature. As explained above, the central idea in this literature is that trade policy is only partly about the maximization of social welfare. Of fundamental importance is the political pressure that comes from various lobby groups including those who provide campaign financing to elected officials. Under these conditions, those who stand to gain the most, and who will therefore be the strongest backers of a RTA, are the producers who are not efficient internationally (i.e. who will find it difficult to compete in the world market), but who are nevertheless more efficient than the producers in the partner countries.

Consider the case of two governments that negotiate an FTA. Since policies are influenced by national welfare and special interests, there are two cases when the FTA is feasible – when it increases consumer welfare and producers are not organized to lobby against it, or when it enhances the profits of well-organized producers that will lobby in favour of the FTA. Grossman and Helpman (1995b) show that the more trade diverting a FTA, the stronger is the support from lobby groups benefiting from it. Therefore, they claim, a FTA is more likely to come about when it is trade diverting. In each country, those producers that are regionally efficient but are not globally efficient will lobby to obtain preferential access to the regional market. If two governments can swap trade-diverting concessions, trade diversion is good politics even if it is bad economics and the governments will form the FTA.

In a free trade area, external tariffs of the members are not identical and rules of origin are used to determine whether a good is eligible for preferential treatment. Following the example above, suppose that the least efficient producer of a certain good is located in the FTA member country with the highest external tariff, while the regionally efficient producer is located in the FTA member country with the lowest external tariff. Creating the FTA integrates the markets of the members, and as a result, the regionally efficient (but globally inefficient) producer gains privileged access to its partner's market while at the same time benefiting from the protective effect of the highest external tariff. Thus the use of the term "enhanced protection".

### *(iv) Increasing bargaining power*

Another argument for trade cooperation is that countries may want to form a RTA to increase their bargaining power in the context of multilateral negotiations (Mansfield and Reinhardt, 2003). This argument is likely to be most important for small developing countries. A World Bank study (Andriamananjara and Schiff, 1999) argued that increased bargaining power at the international level provides an explanation for why a regional grouping like CARICOM, which is made up primarily of very small states, might arise. Given the small size of the countries concerned, trade integration provides limited economic benefits. The creation of a regional grouping will bring benefits through savings on international negotiation costs and giving the countries concerned a larger voice in the international arena.

<sup>64</sup> The insurance motive is closely linked to the domino theory of regionalism proposed by Baldwin (1996). See Section C for a discussion of this theory.

However, the creation of a regional bloc does not necessarily work to increase the bargaining power of its member countries. For example, if member countries are characterized by very different economic interests, it will be relatively easy for opposing negotiators to undermine the deal by making offers that suit the interests of some countries to the point of inducing their defection. This explains why historically the most successful negotiating blocs have been those formed on product-based alliances, such as OPEC or the Cairns Group. Both blocs had a common interest in achieving liberalization on a common export sector – oil and agriculture, respectively.

Furthermore, there are circumstances where the creation of a RTA may even weaken the bargaining power of its member countries. This may occur, for example, in the context of negotiations with a multinational that is considering investing in a certain country, say A. Suppose that, in order to invest in country A, the multinational demands tax concessions. In the absence of a FTA, the government of country A can bargain these concessions against market access (if the multinational does not invest in country A, its product will have to face trade barriers to be commercialised in country A). But, if country A is member of a FTA, the multinational can locate in any country of the region – choosing the one that offers the best tax conditions – and benefit from duty free access in the whole region, including country A. The bargaining power of the government in country A is undermined. The FTA member countries will compete with each other to attract the multinational company in their own country by offering the best deal. This will trigger a race to the bottom that can only be avoided if countries delegate decisions over tax matters to the region.

### 3. INSIGHTS FROM INTERNATIONAL RELATIONS THEORIES ON INTERNATIONAL COOPERATION

So far, we have examined economic and political-economy approaches to trade cooperation. International cooperation and the factors that promote or inhibit such cooperation have also been analysed from a range of different theoretical perspectives in the International Relations (IR) literature.<sup>65</sup> The aim of this section is to discuss the similarities between economic and IR approaches to trade cooperation, and, more importantly, to highlight the additional insights the IR literature can offer over and above the purely economic and political-economy explanations analysed so far.

#### (a) Efficiency, power, norms and ideas: a brief introduction to IR theories of cooperation

IR approaches to the study of international cooperation and institutionalization can significantly contribute to the analysis of cooperation in the field of international trade. Various theories allow for an understanding of how international cooperation in trade matters is shaped by efficiency considerations, power and distributional conflict, and shared norms and ideas. Box 2 gives a schematic overview and short characterization of the most important IR theories of cooperation. For reasons of parsimony, however, the main text of this section will focus on the “grand theories” of IR, and how they explain rationales for international trade cooperation.<sup>66</sup>

A useful starting point is to distinguish between rationalist approaches, on the one hand and more sociological approaches on the other. Two prominent theories of international cooperation – neoliberal institutionalism and neorealism – are rationalist in the sense that they regard states “as self-interested, goal-seeking actors whose behaviour can be accounted for in terms of the maximisation of individual

<sup>65</sup> Many IR theorists have adopted the definition of “cooperation” originally advanced by Robert Keohane according to which cooperation occurs when ‘actors adjust their behaviour to the actual or anticipated preferences of others, through a process of policy coordination’. Keohane (1984: 51); Grieco (1990: 22); Milner (1998: 7). For overviews of IR theories on international cooperation and institutionalization see, for example, Simmons and Martin (2002), Hasenclever et al. (1997, 2000), Krasner (1999: 43-72), Martin and Simmons (1998), Snidal (1997), Haggard and Simmons (1987) and Kratochwil and Ruggie (1986).

<sup>66</sup> The IR theories of neorealism, neoliberal institutionalism, liberalism, and constructivism, which will be explained in detail below, are often called the ‘grand theories’ of IR.

utility" (Hasenclever et al., 1997: 23).<sup>67</sup> As will be shown below, both neoliberal institutionalism and neorealist approaches have been widely used in the study of the post-war trade regime. Whereas neoliberal institutionalists focus on the efficiency-enhancing qualities of trade agreements, neorealist theories tend to stress the importance of power capabilities and distributional conflict as key factors determining the prospects of international cooperation in the area of trade.

In contrast to the rationalist orientation of neoliberal institutionalism and neorealism, theories commonly referred to as "social constructivist" adopt a more sociological view of the international system. Social constructivist theories emphasize the normative and inter-subjective dimension of international cooperation and reject the view that cooperation and institutionalization can be adequately explained by strategic interaction between utility-maximising states.<sup>68</sup> An early example of the use of social constructivist theory in the analysis of the international trade regime is Ruggie's seminal article on "embedded liberalism", which analyses the multilateral trading system as an "inter-subjective framework of meaning".<sup>69</sup> Constructivism has been applied less frequently to the study of the trade regime than neoliberalism and neorealism,<sup>70</sup> but as will be shown below, it opens new and impressive perspectives on trade cooperation.

Some IR theories reject the "statist" assumption that nations are unitary actors with a fixed utility or set of norms and values. These approaches are concerned with investigating how domestic interaction shapes preferences and norms of trade policymakers in charge of formulating national trade policy and negotiating international trade agreements. Assessing trade policy on the sub-state level, these theories stress the role of various domestic government entities and non-state actors, such as lobby groups or non-governmental organizations (NGOs). They analyse how these groups interact in an effort to shape trade policy. Rationalist approaches to domestic trade policy generation are called "liberalist", and examine the role of individuals and interest groups as the fundamental actors in world politics. Liberalists claim that the rational rent-seeking behaviour of special interest groups and elites influences or even determines the actions of elected officials and bureaucrats. "Weakly cognitivist" theories of preference generation, on the other hand, advance the constructivist contention that domestically generated norms, values, customs and traditions have critical effects on public officials and trade decision-makers.

## Box 2: A schematic overview over IR theories of cooperation

The Chart below presents a stylised and simplified overview of influential IR theories of international cooperation. The various strands of IR theory can be sketched along two dimensions: the vertical axis distinguishes between different underlying assumptions of decision-making. Rationalist theories assume that actors – the presence of informational constraints and environmental imperfections notwithstanding – take decisions with the strict aim of maximising some utility function. They do so by rationally weighing up costs and benefits of cooperation. One rationalist strand of literature thereby assumes that all negotiating parties are driven by mutual efficiency concerns. Each cooperating party is believed to bargain for that solution which maximises the "size of the pie" that cooperation generates.<sup>71</sup> Another theme of the rationalist conception assumes that players try to maximise their relative power position. To proponents of this view, international cooperation is akin to a zero-sum game, where gains to one party necessarily come at a loss to another one (the

<sup>67</sup> On the use of rational choice-based theories in IR theory see, for example, Snidal (2002).

<sup>68</sup> On constructivism in IR theory, see, Adler (2002); Guzzini (2002); Wendt (1999), Checkel (1998); Ruggie (1998); Reus-Smit (1997); Finnemore (1996); Kratochwil (1989).

<sup>69</sup> See Ruggie (1983).

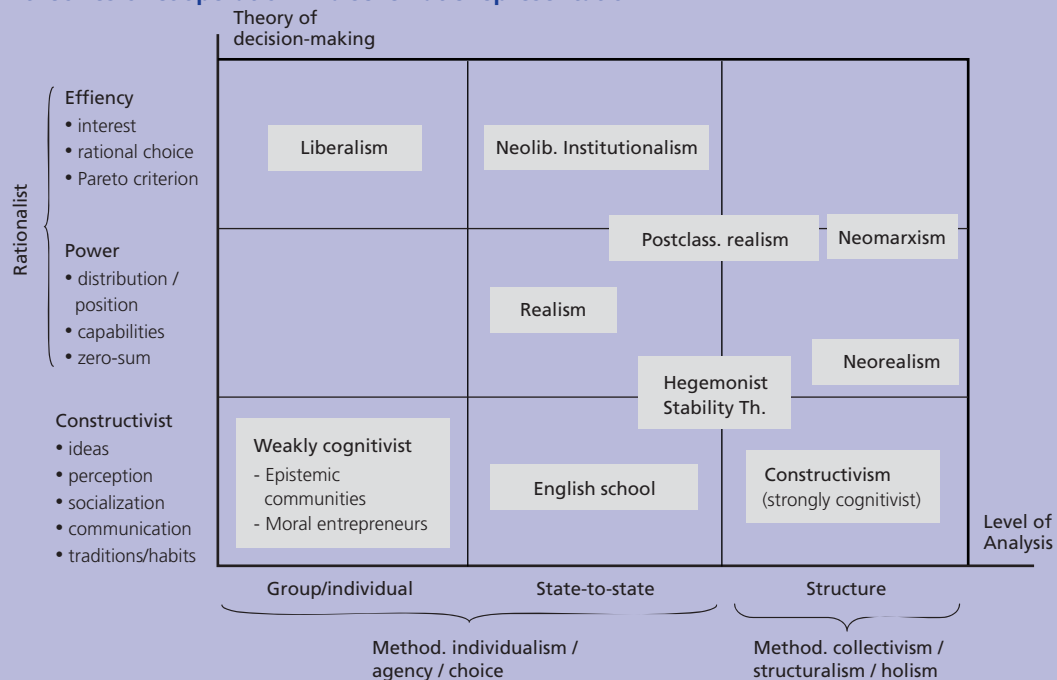
<sup>70</sup> See Lang (2006: 83).

<sup>71</sup> In other words, these theories believe that signatories to a contract strive for "Pareto efficiency", which maximises the absolute gains of interaction. Pareto efficiency is an equilibrium outcome reached when no negotiating party can be put into a better position without making any other agent worse off.

“size of the pie” hence is thought to be fixed). Therefore, cooperating parties anxiously watch over their power rank within the international system.<sup>72</sup> Non-rationalist approaches to decision-making reject the assumption that agents are only driven by rigid cost-benefit considerations. To them, decision-making is much better explained by resort to fundamental norms, shared ideas, inter-subjective beliefs, traditions, and habits. Perception, interpersonal communication, learning and socialization to a large degree shape these norms and ideas.

The horizontal axis can be labelled “level of analysis”. The distinguishing criterion is the object of examination. Theories pertaining to methodological individualism or agency believe that agents – individuals, groups, or states – can actively and consciously shape the consequences of their interaction. Agents’ choice is thought to determine the outcome (the system). In contrast to this, theories adhering to the school of methodological collectivism, structuralism, or holism, contend that it is the system that shapes the actors and not vice-versa. The system, according to structuralists, is more than the sum of its constituent parts, and therefore assumes “a life of its own”. Systems shape how agents think and act. Along those two dimensions the various schools of IR can be plotted:<sup>73</sup>

**IR theories of cooperation in a schematic representation**



Source: Based on Wendt (1999); compilation by the authors.

The school of neoliberal institutionalism is a rational statist approach to international cooperation.<sup>74</sup> According to institutionalists, countries cooperate with the substantive aim of increasing mutual efficiency.<sup>75</sup>

<sup>72</sup> Distributive concerns are sometimes referred to as “Kaldor-Hicks efficiency”. Under this conception of efficiency parties worry about relative gains, and largely ignore (or take for granted) absolute gains.

<sup>73</sup> Ikenberry et al. (1989) classify IR approaches in a similar fashion along the following two dimensions: level of analysis (system-centred, society-centred, state-centred) and driving forces (power, interest, norms/ideas).

<sup>74</sup> The school of neoliberal institutionalism is also referred to as “rational functionalism”.

<sup>75</sup> Efficiency gains may be achieved by reducing uncertainty, increasing mutual information levels, producing collective goods (such as forums for bargaining and dispute settlement), centralizing certain tasks so as to reduce transaction costs, raising the costs of opportunistic actions (e.g. through repetition of the game or through pooling of enforcement capabilities), and so forth.



Scholars of liberalism part with the somewhat arbitrary idea that states are unitary actors with a steady utility function. In order to explain what motivates countries to cooperate in the international realm, liberalists firmly base their research on domestic politics. Cooperative agreements are concluded if the decision to collaborate is the equilibrium outflow of some rational deliberation process among salient domestic groups.

Neomarxist or “world systems” analysis is a structural approach to international cooperation giving primacy to economic power relations. World systems analysis is usually grounded in the Marxist conception of social reality. The central argument is that the world economy contains two sorts of countries: a dominant core and a dependant periphery. Core and periphery interact and function as an integrated whole. In a unified global capitalist system the hierarchy of states is held together by economic dependency. The periphery is the source of the wealth of the core; the latter extracts and siphons off the resources of the former. This produces underdevelopment throughout the dependent periphery.<sup>76</sup> Hence, countries at the core (industrialized countries) create alliances with each other to choreograph the “development of underdevelopment” (Frank, 1969: 9). Trade cooperation agreements between core and periphery are more akin to adhesion or dependency contracts than to contracts of mutual consent and benefit.<sup>77</sup>

Realism is a state-centric, power-oriented approach to international relations. It is the longest-standing paradigm in IR, and was dominant from at least the 1930s to the 1970s (Simmons and Martin, 2002).<sup>78</sup> Realists contend that states strive for power maximization. Countries candidly act in ways that satisfy their power interests. Realist scholars have shown interest in issues of military security and less in international trade. Hence, international trade cooperation does not feature prominently in realist thought, and where it does, its proponents see the hand of power exerting the true influence behind the façade of international agreements (Morgenthau, 1948). Generally, treaties and international law are “epiphenomenal” to state power and interests (Carr, 1939).

The neorealist school is usually seen as the successor of realist thought. However, neorealism is a systemic power-oriented approach to international affairs. The international system is characterized by anarchy. In a state of anarchy, any nation is exclusively occupied with its own survival (Waltz, 1954). To that end, each nation must watch its power position in the international system. Countries predominantly care about military capabilities and the distribution of coercive power within the system. Interaction among rational countries is assumed to be a zero-sum game. To maintain (or improve) their power rank, countries utilize their own resources, or form (spontaneous) short-term international alliances or blocs. Alliances can temporarily mitigate anarchy, but never overcome it.

A milder form of realism is called postclassical realism or defensive realism. The view of the world here is somewhat less pessimistic. Postclassical realists argue that power, while an important dimension of state interaction, is not an end in itself. Rather it is but a means of achieving security and increasing the resource-base of a country. For proponents of this view, countries choose cooperation so as to reduce the probability of conflict, help overcome international externalities, and increase the welfare of a country.

<sup>76</sup> According to world systems theorists, there exists an inherently unfair international division of labour, where modern high-profit industries are located in the core and traditional labour-intensive industries and natural resource extraction originates in the periphery. This division of labour produces capital accumulation and development in the core, and yields economic and political underdevelopment in the periphery. The more the world economy progresses, the more difficult it is for the periphery to develop, and the greater is the revolutionary effort required to escape global market forces.

<sup>77</sup> Early formulations of world system analysis include Wallerstein (1974), Baran (1967), and Frank (1969). For more contemporary approaches, see e.g. Chase-Dunn (1998).

<sup>78</sup> The earliest available works of realism – Thucydides and Sun Tzu – date back further than 400 B.C.

Hegemonic stability theory is another variant of realism. It takes a more nuanced stance on international cooperation: an incumbent hegemon (such as the United States after World War II) aims at fortifying its predominance in the international system through cooperation. At the same time, the hegemon wants to forge a global community of values, and aims to inject some of its cherished norms and ideals into the system. In addition, only the hegemon as the most powerful state in the system is in a position to address international collective action problems so as efficiently to fight global externalities, such as environmental pollution or opportunistic beggar-thy-neighbour trade policies.

Constructivist approaches to the discipline of IR reject the method of rational choice and agent-centred methodological individualism that all of the above perspectives maintain. Strongly cognitivist constructivists claim that rationalist theories of choice fail on two accounts. Firstly, they neglect the formative influence of ideas, norms and values on behaviour. They therefore propose to replace the “logic of consequences” with a “logic of appropriateness”, so that norm-based decisions substitute rational, self-interested choice. Secondly, rational choice theories fail to acknowledge the influence that the system has on the actors. The power of inter-subjective beliefs, shared understanding, culture and socialisation, according to constructivists, is completely overlooked by agent-centric theories of choice. Hence, for proponents of the strongly constructivist stance, the dictum “actors’ preferences shape the outcome” is false. Instead, system and agents are strongly interdependent; the structure shapes actors’ perceptions, perception shapes agents’ preferences and consequently their behaviour. Collective behaviour then can have a feedback impact on the system.

A variation of structural constructivism (and arguably its forerunner) is the English school of IR. This theory is less concerned with how the system shapes states’ norms, but rather with the transnational diffusion of certain international norms and values. Its proponents have emphasized the importance of international society in maintaining global order. The concept of “collective security” is a good example, showing how like-minded countries form a coalition to inject their defensive aims into the international system.

Weakly cognitivist approaches, finally, examine how guiding norms and principles emerge, become prominent and consequently influence the cooperative choice of domestic decision-makers. The roles of eminent individuals (moral entrepreneurs), elites, and epistemic communities are paramount in this process.

Some caveats to this schematic representation of IR theories are in order: first, the selection of approaches is necessarily eclectic. It is illustrative rather than exhaustive. Second, it is always a challenge to allocate IR scholars to a particular school of thought. Naturally, authors do not religiously adhere to a particular IR theory. Scholars draw selectively from those approaches they feel best explain social behaviour and human interaction. Third, the classification of theories is not as clear-cut and rigid as it may appear. Theoretical and dogmatic debates have evolved over time. Cross-fertilization between views has produced hybrid approaches that embrace aspects of various schools of thought. Finally, historic paradigm shifts (such as the end of the Cold War or the decline of US hegemony) and technical innovations within IR (such as advances in game theory and the increased use of econometric tools) have influenced the popularity and prominence of different schools.

## (b) “Statist” approaches to trade cooperation: states as actors

Various schools of IR take a statist perspective on international trade cooperation. Their subjects of examination are sovereign nation states that are assumed to be unitary actors in the international system.

### (i) *Rationalist approaches to the study of international cooperation: market failure, power and distribution*

#### *Focus on efficiency: neoliberal institutionalism*

Neoliberal institutionalism argues that cooperation between states can be explained in terms of calculations of self-interest. The fundamental insight of this theory is that collective action dilemmas, transaction costs and information asymmetries and deficits may create situations in which behaviour that is rational from the perspective of individual states prevents them from realising mutual benefits, as illustrated by the prisoners’ dilemma metaphor. In such situations, international regimes, or institutions,<sup>79</sup> enable states to cooperate by providing information, reducing uncertainty and lowering transaction costs, i.e. the costs of shaping, monitoring and enforcing rules.<sup>80</sup> Regimes facilitate cooperation in that they influence cost-benefit calculations of alternative courses of action by states. In its original formulation by Keohane (1984) a central feature of neoliberal institutionalism was that cooperation between states does not require a formal international organisation with centralised enforcement capacity. Rather, regimes are self-enforcing agreements, and compliance with a regime’s rules can be explained by reciprocity and the role of reputation.<sup>81</sup> Thus, neoliberal institutionalism stresses the bilateral and decentralised nature of international cooperation regimes.<sup>82</sup>

Applying this logic more concretely to the field of trade cooperation, it becomes clear that neoliberal institutionalism and prominent economic theories of trade agreements share many properties. Externality-based theories in trade, especially the terms-of-trade approach, are agent-centred, statist, and efficiency-minded approaches to trade cooperation. Those market imperfections, externalities and inefficiencies that international trade cooperation can overcome according to neoliberal institutionalism, can also be understood as world-price externalities that feature so prominently in the terms-of-trade theory. Moreover, from a neoliberal institutionalism perspective trade agreements can be viewed as mitigating collective action problems which arise from economic considerations. If no two countries want to shoulder the costs of drafting, launching, and maintaining a trade agreement from which everybody benefits, the conclusion of a multilateral regime will solve this problem by providing a public good to the benefit of the international trading system.<sup>83</sup>

<sup>79</sup> There is no consensus definition of the term “international regime” in the IR literature. One influential characterization of “international regime” is a set of ‘principles, norms, rules and decision making procedures around which actors’ expectations converge in a given area of international relations.’ (Krasner, 1983: 2). For a discussion of the different definitions of “international regime” used in IR theory, see for example, Hasenclever et al. (1997: 8-22). Although some theorists prefer the term “institution” over “regime” (Simmons and Martin, 2002:194), the former term has also been used in widely different ways in IR theory (see, for example, Buzan, 2004; Holsti, 2004). However, for the present purposes of explaining rationales for trade cooperation, it is inconsequential whether trade agreements are regimes or institutions. Yet one thing is evident – trade agreements as regimes or institutions are more than just contracts, which is the way economists tend to conceptualise trade cooperation.

<sup>80</sup> See Keohane (1984). See also Keohane (2005: xi): “International regime – clusters of principles, norms, rules, and decision-making procedures reduce transaction costs for states – alleviate problems of asymmetrical information, and limit the degree of uncertainty that members of the regime face in evaluating each others’ policies. Like other political institutions, international regimes can be explained in terms of self-interest. Furthermore, they exert an impact on state policies largely by changing the costs and benefits of various alternatives. They do not override self-interest but rather affect calculations of self-interest.” Although neoliberal institutionalism is the term generally used in the IR literature to refer to Keohane’s work, the author himself has rejected the label “neoliberal” (Keohane, 2002: 3).

<sup>81</sup> Later versions of neoliberal institutionalism have departed from Keohane’s functionalist approach, and attached more weight to the importance and influence of formal international organizations as cooperation facilitators, see section C.1.(c) below.

<sup>82</sup> See Abbott and Snidal (1998). The theory was significantly influenced by the experience of the GATT trade regime in the 1970s and 1980s. Keohane (2005: xi) observes that ‘indeed, it could be argued that my theory generalizes the experience of GATT’.

<sup>83</sup> On the public-good nature of trade agreements, see section C.1.(d) below.

Although neoliberal institutionalism usually focuses on the prisoners' dilemma as representing the typical collective action dilemma in international relations, its logic has also been applied to other patterns of strategic interaction between states. Several authors have attempted to explain the likelihood of the formation of an international regime (and the formal characteristics of different regimes) by referring to different "strategic structures" of the underlying collective action problems (e.g. Aggarwal and Dupont, 1999 and 2004; Ostrom, 2003; Sandler, 1992). A common distinction in this context is that between collaboration problems and coordination problems.<sup>84</sup> It is often argued that collaboration regimes are typically more formalized and institutionalized with regard to surveillance and enforcement than coordination regimes. Unfortunately, it is understudied in the institutionalist literature, in what respects trade agreements can be conceptualised as coordination games, and what impact this would have on the design of trade agreements.<sup>85</sup>

### Focus on distribution: the school of neorealism

Whereas neoliberal institutionalism highlights the role of international cooperation in enabling states to solve market failure and other efficiency problems, and thereby to achieve joint efficiency gains, neorealist approaches to the study of international cooperation reject the proposition that market failure in this sense is a fundamental problem in international relations. Neorealists emphasize the role of "power and distribution rather than information and joint gains. The basic issue is where states will end up on the Pareto frontier, not how to reach the frontier in the first place."<sup>86</sup> Consequently, proponents of this theory question the relevance of the prisoners' dilemma metaphor and posit that a more pertinent game-theoretic model is that of the "battle of the sexes", a coordination game with two possible negotiation equilibria. Players have conflicting preferences regarding the two optima.<sup>87</sup>

In this respect, several authors have rejected the view that the prisoners' dilemma metaphor adequately represents the configuration of interests of states in the field of international trade.<sup>88</sup> According to neorealist theory, countries thus do not cooperate to reap primarily welfare-enhancing mutual efficiencies. Instead, states try to "squeeze out" as many concessions from other players in order to be propelled onto a higher power rank.

Neorealist theory contends that it is exactly questions of distribution that make cooperation difficult to achieve in the first place. It is argued that as a consequence of the anarchic nature of the international system, states will often refrain from participating in efficiency-enhancing international cooperation regimes when they suspect that other states will realise greater gains.<sup>89</sup> This concern about "relative gains" is due to the fact that economic profits can eventually be transferred into military capability.

<sup>84</sup> See Stein (1983); Martin (1993). In a nutshell, in collaboration games – such as the prisoners' dilemma – parties have partially conflicting interests, namely those of acting opportunistically by cheating the other party. Opportunism is not a problem in coordination games (such as the "battle of sexes" game). There, no party gains from defecting. Cooperating parties join forces so as to reap mutual transaction efficiencies or synergies. However, coordination games are nevertheless not free from disagreement: typically, there exist more than one Pareto-efficient equilibrium outcome. States then collectively must choose one of various welfare superior equilibria. Different equilibria thereby are preferred by different players. This creates tensions and disagreement among the cooperating parties.

<sup>85</sup> Trade agreements based on "minimum standard" or "positive integration", such as the WTO Agreement on Trade-Related Intellectual Property Rights (TRIPS), or the Agreement on Trade-Related Investment Measures (TRIMs) of the WTO may be properly conceptualised as collaboration games, where all parties know that conceding to some level of regulation is mutually efficiency-enhancing. However, disagreement may arise among the signatories over the question what the optimal level of cooperation really is.

<sup>86</sup> See Krasner (1991: 140).

<sup>87</sup> Applied to the less clinical setting of a 2-by-2 matrix, theories of distribution contend that cooperation over complex issues usually yields a vast amount of self-enforcing equilibria that two or more parties prefer to no agreement. However, parties are in vivid disagreement in their subjective rankings of the mutually preferable agreement candidates. Adding realism by considering dynamism, uncertainty, and asymmetrical information about other parties' "bottom line" makes clear that virtually all contexts of international cooperation involve distributional conflict over the terms of cooperation (Fearon, 1998).

<sup>88</sup> See, for example, Goldstein (1993). Gowa and Mansfield argue that the prisoners' dilemma metaphor fails to reflect the most critical aspect of free trade agreements in an anarchical system – the existence of security externalities. Gowa and Mansfield (1993), Gowa (1989).

<sup>89</sup> See Grieco and Ikenberry (2003: 103-105), Mearsheimer 1995), Grieco (1988), (1990).

“Driven by an interest in survival and independence, states are acutely sensitive to any erosion of their relative capabilities”.<sup>90</sup> Thus states are not seen as rational egoists but as “defensive positionalists.”.<sup>91</sup>

At face value, the neorealist relative gains hypothesis thus seems unhelpful in explaining why countries enter into trade agreements – it rather gives reasons for why countries refrain from cooperating. However, the relative-versus-absolute gains issue has spawned a lively debate about the extent and boundaries of trade cooperation. It has focused attention on whether security-related relative gains decrease the prospect for international cooperation, and whether – as an empirical matter – states are concerned about such relative gains at all.<sup>92</sup> Joseph Grieco has argued that an analysis of the implementation of some of the Tokyo Round Agreements on non-tariff barriers supports his theory on the importance of security-related relative gains.<sup>93</sup> This analysis, however, has been subject to widespread criticism in the literature.<sup>94</sup> The prevailing view seems to be that the significance of the relative gains problem depends upon various factors, including the number of states involved. Relative gains seem to matter less in a multilateral than in a bilateral context.<sup>95</sup>

Lloyd Gruber stresses the importance of global power-divides with respect to trade agreements. The author challenges the contention that trade cooperation is mutually welfare-enhancing. He argues that the fact that states enter into cooperative arrangements on a voluntary basis does not mean that such arrangements are necessarily welfare-improving for all participants. If powerful countries, through the exercise of “go it alone power” can alter the status quo and thus remove the original status quo from the choice set of weaker states, weaker players must either accept an agreement that is worse than the status quo ante or accept to be left behind in conditions that are even more disadvantageous.<sup>96</sup> Therefore, entering into cooperative arrangements can leave nations in a worse position relative to the status quo ante. The concept of “go it alone power” and the concomitant idea that states are forced to enter into international agreements that leave them worse off compared to the status quo ante have recently also been used by some authors in the analysis of GATT/WTO negotiations.<sup>97</sup> Trade agreements thus may not be concluded because countries want them, but because they are coerced to do so by powerful countries whose aim is to create dependency, or to exploit weaker countries. For this post-colonial perception of trade cooperation, see e.g. Jawara and Kwa (2004).<sup>98</sup>

The idea that international cooperation should be understood either in terms of the efficiency considerations emphasized by neoliberal institutionalists, or in terms of the distribution concerns stressed by neorealists has recently been criticized. James Fearon argues that the collaboration-coordination dichotomy is misleading, because all problems of international cooperation have a common strategic structure. The author contends that international cooperation always first involves a problem of bargaining about the distribution of future cooperation gains. This bargaining is akin to a coordination game. Secondly, cooperation games involve a problem of enforcement and monitoring, which is akin to

<sup>90</sup> See Grieco (1990: 39).

<sup>91</sup> As was mentioned in Box 2 above, the relative gains concern of neorealists stands in contrast to absolute gains concerns of neoliberal institutionalists who claim that countries strive for welfare maximisation, and are largely agnostic about gains that other countries carry away from the mutual cooperation. Interestingly, Grieco (1990: 234) does not argue that concerns about relative gains mean that international institutions do not matter. To the contrary, a focus on relative gains helps explain certain functions of international institutions such as the provision of formalised side-payments by which strong members can compensate weaker members.

<sup>92</sup> See Baldwin (1993).

<sup>93</sup> See Grieco (1990: 168-215).

<sup>94</sup> See, for example, Gruber (2000: 22-27), Fearon (1998: 288), Morrow (1997), Keohane (1993), Powell (1991) and Snidal (1991).

<sup>95</sup> See also Grieco and Ikenberry (2003: 104-105).

<sup>96</sup> See Gruber (2000).

<sup>97</sup> See Steinberg (2002: 341, 349), Barton et al. (2006:206).

<sup>98</sup> Notice the substantial similarity between this coercion argument and the economic insurance model of trade cooperation discussed in subsection 2.(d) above. Only the rhetoric is different.

a prisoners' dilemma game of collaboration.<sup>99</sup> Whereas an approach that treats a prisoners' dilemma as the key problem in international cooperation leads to the expectation that states will have little difficulty in cooperating once countries possess enough deterring enforcement and monitoring capacity, different and more nuanced predictions result when a distinction is made between the bargaining phase and the enforcement phase of international cooperation. According to Fearon, bargaining problems are often more important obstacles to international cooperation than monitoring and enforcement.<sup>100</sup> The author thus argues that "regimes deserve greater attention as forums for bargaining rather than primarily as institutions that aid monitoring and enforcement" (*ibid.*: 298).<sup>101</sup>

Applying Fearon's analysis to the field of trade agreements does not tell us why countries cooperate in trade. Yet the author directs attention to the inherent obstacles in the run-up to a successful conclusion of a trade deal.<sup>102</sup> Moreover, his approach can also be seen as helpful in understanding the structure of negotiations. In order to overcome the problem of distributional conflicts over the expected gains from trade cooperation, and to reach agreement at all, countries make efforts to structure the negotiation process. All these strategies are aimed at reaching a speedy agreement, to mitigate long-winded distributional conflicts, and to prevent a breakdown of negotiations. Side payments and issue linkage, for example, are ways of cutting short the bargaining process.<sup>103</sup> Gradualism (the concept of trade rounds) is apt to decrease the "shadow of the future". A shorter shadow of the future reduces the size of anticipated gains from trade and thereby the incentive to renegotiate endlessly. A structured bargaining process of offers and counter-offers reduces negotiation frictions. Regular high-level meetings and artificially high political costs of failure (e.g. the "single undertaking" scheme applied in the Uruguay Round of the GATT) are strategies aimed at "upping the stakes" in case of a negotiation meltdown, and at reducing parties' incentives to hold out on each other in the negotiation process.

### Focus on the dominant power in the international system: hegemonic stability theory

The theory of hegemonic stability asserts that the creation and maintenance of an open international order requires the presence of the one state that is endowed with a preponderance of power resources relevant to the particular issue area, and that a more equal distribution of power capabilities will lead to a decline of the regime.<sup>104</sup> Only the hegemon can overcome international market failure and provide global public goods.

Although hegemonic stability theory is seen as flawed by many theorists,<sup>105</sup> it remains an important concept in studies of international cooperation. For example, it has been argued that a hegemonic power faces the problem of how to assure other states that it will not act opportunistically. In this regard, it has been suggested that the United States encouraged the formation of the post-war international

<sup>99</sup> See Fearon (1998: 270, 275-276).

<sup>100</sup> While 'a long shadow of the future may make enforcing an international agreement easier, it can also give states an incentive to bargain harder, delaying agreement in hopes of getting a better deal.' (*ibid.*: 270).

<sup>101</sup> Fearon's contribution underlines a point made by Snidal that "almost all international cooperation problems mix efficiency and distribution concerns" (Snidal, 1997: 485; see also Morrow, 1994).

<sup>102</sup> "...the major obstacles to the conclusion of each of the last three GATT rounds were not intractable problems of monitoring, commitment, enforcement, or information flows to make enforcement possible. Instead negotiations have regularly stalemated on questions of who would make the concessions necessary to conclude an agreement" Fearon (1998: 289).

<sup>103</sup> The inclusion of TRIPS serves as an example of issue linkage and side-payments geared towards reaching consent in the Uruguay Round.

<sup>104</sup> See Kindleberger (1973); Krasner (1976); Gilpin (1987).

<sup>105</sup> See e.g. Strange (1982), Conybeare (1984), or Snidal (1985). Empirical studies have found little support for hegemonic stability theory in its crude form. Hegemonic stability theory has also been criticised on theoretical grounds. One major theoretical argument advanced against the theory is that it incorrectly assumes that an international regime is a public good. Thus, for example, many analysts take the view that free trade and the GATT regime are not public goods (cf. the discussion in section C.1.(d) below). Another argument is that, even assuming that international regimes are public goods, such goods can also be provided by groups of states sufficiently small for each state to notice whether or not other states in the group are contributing to the provision of the collective good ("k-group"; Milner, 2002; Hasenclever et al., 1997; Lake, 1993; Keohane, 1984).

trade regime partly to make its commitment to free trade credible.<sup>106</sup> This may explain the interest of the United States in multilateralism in the 1990's: while the Cold War resulted in a commitment to a stable and prosperous Western Europe and thus decreased "the need for a trade-specific signal of the United States' willingness to adhere to free trade", the end of the Cold War again confronted the United States with the problem of how to assure other states as to the credibility of its commitment to free trade, given its reputation for unilateralism.

(ii) *Focus on ideas, knowledge and values: constructivist theories of the system*

When trying to answer the question of why countries cooperate in trade affairs, sociological or social constructivist theories can be very helpful in revealing the general conditions conducive to international cooperation in trade affairs. Constructivists show that not only norms and values play an important role, but also that history matters. Whereas rationalist theories usually only look at utility, interest, and choice, constructivists contend that lessons learned from the past shape the way governments think about trade cooperation and consequently the decisions they take.

Constructivist theories argue that interest-based, rational choice theories reviewed above fail to account for the role of ideas and knowledge in shaping the identities of states. Structural, or strongly cognitivist theories maintain that the behaviour of states is rule-driven and that international cooperation and institutionalisation cannot be understood without reference to generally accepted normative structures that shape the identities of states.<sup>107</sup> For example, Reus-Smit argues that neither neorealism nor neoliberal institutionalism can explain the historical development of multilateralism. As a fundamental institution of modern international society, multilateralism reflects the constitutional structure of international society consisting of dominant beliefs about the moral purpose of the state, a norm of procedural justice and an organising principle of sovereignty.<sup>108</sup>

As noted above, Ruggie's analysis of "embedded liberalism" is a prominent example of the use of a social constructivist approach to the study of the multilateral trade regime. Ruggie argues that international regimes are social institutions and as such constitute "inter-subjective frameworks of meaning".<sup>109</sup> The formation of international regimes is a manifestation of "the internationalization of political authority". Since political authority "represents a fusion of power with legitimate social purpose", interpretations that exclusively focus only on power, and ignore the dimension of social purpose, are necessarily incomplete.<sup>110</sup> They may manage to explain the form of a regime but not its content. With respect to this dimension of legitimate social purposes, Ruggie emphasizes the fundamental differences between the post-World War II international economic order with the "Bretton Woods Institutions" (World Bank and IMF) and the GATT as its centrepiece, and the liberal economic order prevailing in the 19<sup>th</sup> century (cf. subsection 1.(a) above). According to Ruggie, attempts to reconstruct a liberal international economic regime in the interwar period failed not because of the absence of a hegemonic power but because "even had there been a hegemon, they stood in contradiction to the transformation in the mediating role of the state between market and society, which altered fundamentally the social purpose of domestic and international authority."<sup>111</sup> A fundamental change in social purpose, however, did occur after World War II. It manifested itself in what Ruggie terms "the compromise of embedded liberalism", i.e. the vision shared by leading states that international commitments needed to be compatible with the pursuit of domestic economic policy objectives. "This was the essence of the embedded liberalism compromise: unlike the economic nationalism of the thirties, it would be multilateral in character; unlike

<sup>106</sup> See Goldstein and Gowa (2002: 154).

<sup>107</sup> See Hasenclever et al. (1997: 167-168).

<sup>108</sup> See e.g. Reus-Smit (1997) and Ruggie (1993). But see Martin (1993) for a critical view.

<sup>109</sup> See Ruggie (1983: 196).

<sup>110</sup> See Ruggie (1983: 198).

<sup>111</sup> See Ruggie (1983: 208).

the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism.”<sup>112</sup>

Strongly cognitivist theories assume that it is largely norms and ideas permeating the international system which motivate and shape state-to-state cooperation in trade affairs. However, these theories ultimately remain unclear about the way shared norms, values and beliefs diffuse into the system. An older strand of IR theory, the English school, is occupied with exactly this question. Scholars of the English school emphasize the importance of “international society” in global cooperation. International society is thereby seen as a group of states that share common ideas and coherent goals.<sup>113</sup> A central concern is to explain how shared purposes spread internationally and contribute to order (Bull, 1977). With respect to trade cooperation, special attention is thereby given to a belief in the peace-promoting quality of trade (see Box 3). The idea that multilateral, non-discriminatory trade would contribute significantly to global peace was a central theme in the thinking of English and American policymakers about the design of the post-World War II trading system.<sup>114</sup> Theories of norm diffusion (which draw heavily on historical data) try to show how the vision of peace-through-trade emerged,<sup>115</sup> but more importantly, how some influential states – such as the United Kingdom, the United States, Canada and Australia – went about persuading other countries to join in multifaceted international cooperation.

### Box 3: The peace-promoting quality of trade

The genuine belief that trade “dovetailed with peace” (Hull, 1948: 81) seemed to have been a principal belief among Western Allies in the post-World War II era.<sup>116</sup> In the wake of the Cold War, the Allies entertained the hope that an open international economic order would reduce power balancing and strategic rivalry among the great powers.<sup>117</sup> Post-war European integration is another important example of a trade agreement for which national security was a primary driving motivation.<sup>118</sup>

<sup>112</sup> See Ruggie (1983: 209). Andrew Lang (2006: 83) has recently argued that ‘while the narrative of embedded liberalism itself has been relatively well reproduced, the theoretical framework on which it is based has been neglected.’. In particular, trade lawyers have relied heavily on rationalist approaches in their understanding of the nature of the trading regime and have insufficiently taken account of Ruggie’s characterisation of the trade regime as an ‘inter-subjective framework of meaning’. Lang argues that constructivist insights have the potential to significantly enrich and expand the understanding of the trade regime and of trade law.

<sup>113</sup> English school proponents see international society either as a group of states that have ‘established by dialogue and consent common rules and institutions for the conduct of their relations, and recognize their common interest in maintaining these arrangements’. (Bull and Watson 1984: 1). Alternatively, international society exists because those who speak and act in the name of states assume that it does. (Evans and Wilson, 1992: 32).

<sup>114</sup> See Penrose (1953). The historical record clearly shows that the ITO/GATT was envisioned by the Allied powers to be part of a bigger cooperation scheme that included the establishment of the United Nations, the World Bank, and the International Monetary Fund (see e.g. Jackson, 1969; Dam, 1970; Gardner, 1980).

<sup>115</sup> Economic nationalism and the spread of regional blocs in the 1930s were seen as a major source of conflict and as one of the causes of the war.

<sup>116</sup> The term “commercial liberalism” has been used to describe the view that the mutual dependence generated by international trade promotes international peace.

<sup>117</sup> This hope proved to be in vain. Instead, trade cooperation deepened the trenches between the Socialist Bloc and the West: it has been argued in this respect that in view of the close linkages between economic and security considerations that ‘the opening of the world economy after World War II was given critical support by the system of security cooperation triggered by the Cold War’. (Grieco and Ikenberry, 2003: 157).

<sup>118</sup> European economic integration was seen as a way of ensuring a lasting peace on the continent. The first step taken in this process was the establishment of the European Coal and Steel Community (ECSC). While the stated objective of the ECSC was “to contribute ... to economic expansion, growth of employment and a rising standard of living ...”, the Treaty had a militarily strategic value in putting coal and steel – industries essential to war-making – under a common authority. It had the effect of making sure that “any war between France and Germany becomes, not merely unthinkable, but materially impossible”. (Pomfret, 1997: 89).



Even though the contention that trade and peace dovetail is still very present today,<sup>119</sup> it is not uncontested on theoretical and empirical grounds. A number of IR scholars and political economists stress the importance of increased economic dependency and improved transnational relationships. Economic integration may help to reduce the risk of conflicts for two main reasons. First, negotiations on trade issues help gradually to build trust among governments, thus fostering peace. Second, by advancing specialization, trade liberalization increases dependency among countries, thus rendering conflict more costly and less probable.<sup>120</sup> Critics of this view support a pessimistic prognosis, and stress that asymmetric trade and asymmetric gains from trade may lead to conflicts.<sup>121</sup> Empirical evidence appears to generally support the idea that increasing bilateral trade reduces the risk of bilateral conflicts.<sup>122</sup> But studies can be found that support either side of the argument, predicting both a negative and positive relationship between trade and war.<sup>123</sup>

Influenced by theoretical advances in constructivism, other grand theories of IR have subsequently attempted to integrate the importance of “ideational” motives in a rational choice framework. One influential contribution of neoliberal institutionalism argues that ideas can be understood as “principled beliefs” or as “causal beliefs”. Such ideas can serve as “road maps” that help actors select a course of action that best fits with their normative and analytic understandings. Common beliefs can also serve as focal points that enable states to solve collective action dilemmas where there exists more than one equilibrium outcome.<sup>124</sup> Finally, ideas can influence states when they are embodied in institutional frameworks.<sup>125</sup> In the latter regard, Judith Goldstein has applied the insight that international institutions legitimate and disseminate ideas and norms to the GATT/WTO. The author argues that “free trade ideas are embedded in an extant group of international institutions” including the GATT/WTO and the IMF. (Goldstein, 1998: 146-147).<sup>126</sup>

Proponents of hegemonic stability theory also have integrated constructivist ideas into their theorizing. Ikenberry has pushed for a liberal version of hegemonic stability theory (also called leadership theory). Leadership theory discusses the nature of an incumbent hegemon. The author questions the understanding of hegemonic order built simply around the exercise of material capabilities (military power, control over raw materials, markets, and capital; or competitive economic and technological advantages) and argues

<sup>119</sup> Keohane argues that ‘commerce on a non-discriminatory basis within an orderly political framework promotes cooperation on the basis of enlightened national conceptions of self-interest that emphasize production over war’. (Keohane, 2002: 49).

<sup>120</sup> Both these arguments apply equally to multilateral and regional trade agreements. Yet, it is countries that are geographically close to one another or who share a common border that have a strong stake securing a peaceful neighbourhood. Regional economic integration is then one vehicle through which past or potential antagonisms can be managed and eventually erased.

<sup>121</sup> See Barbieri and Schneider, 1999 and Kapstein, 2003 for recent surveys.

<sup>122</sup> There is too little evidence to evaluate the impact of trade on extra-regional conflicts.

<sup>123</sup> For the contention that trade has a negative impact on international peace, see for example, Polachek (1992; 1997). For the opposite view, see Barbieri (1996; 2002). In general, these studies do not test the robustness of their results against the possibility that the relationship is determined by the feedback effect of war on trade. A recent study (Martin et al. 2005), based on data on military conflicts in the period 1948-2001, shows that when this feedback is taken into account, increasing bilateral trade between two countries reduces the probability of conflicts between them.

<sup>124</sup> Ideas as focal points arguably gain special prominence when actors’ preferences are not particularly strong on a certain issue, or interests are mutually ‘balanced’. Agents then look for roadmaps or focal points to guide them to an equilibrium outcome.

<sup>125</sup> See Goldstein and Keohane (1993); Keohane (2002: 5-6); Hasenclever et al. (1997: 143-144). On the importance of formal international institutions, see section C.1 below.

<sup>126</sup> Goldstein (1998: 146-147) emphasizes that the free trade norms institutionalized in the WTO are not ‘akin to the free trade models found in an economic textbook. The ideological foundations of the trade regime are a hybrid, coupling trade openness with domestic stability – the liberalization of trade among nations was never a goal in itself but rather a means to domestic economic growth.’

that the hegemon aims to inject some of its cherished norms and values into the system.<sup>127</sup> By focusing on prestige and moral leadership the hegemon wishes to maintain its hegemonic position (e.g. Ikenberry and Kupchan, 1990).

### (c) “Non-statist” theories of trade cooperation

A key weakness of all statist theories is that they treat states’ preferences and/or norms as exogenous.<sup>128</sup> An important development in IR theory over the last two decades has thus been the revival of interest in domestic agents. Recent theories have abandoned the concept of the state as a unitary actor and replaced it by a “sub-state” level of analysis. Central to this IR literature is the question how international cooperation is affected by domestic politics and norms.<sup>129</sup> Non-statist theories of trade cooperation opened the black box of states’ utility functions and norm bundles. Domestic approaches to cooperation can be seen as falling into two categories: the rationalist school of thought (“liberalism”), and the “weakly cognitivist” school of thought that closely follows a constructivist methodology.

#### (i) *Focus on domestic politics: the theory of liberalism*

Andrew Moravcsik has formulated a “liberal theory of international relations” that stresses the role of individuals and private groups as the pivotal actors in world politics, and which he claims to be analytically superior to realism and neoliberal institutionalism.<sup>130</sup> The government represents a subset of domestic society. Self-interested government officials define state preferences according to influences of various domestic non-state agents, and act purposively in world politics. Representative institutions and domestic processes translate the preferences of pivotal individuals and social groups into state policy. As a consequence, the country is not an independent actor but merely an agent of multiple principals, who have interdependent, and partially conflicting, preferences. Nations pursue their endogenous preferences under constraints imposed by the preferences of other states.<sup>131</sup>

Whereas neorealist and neoliberal institutionalist theories explain the rationale for an international regime in terms of distribution of power capabilities or of reducing transaction costs, liberal IR theory emphasises the importance of the “social embeddedness” of a regime; international regimes are created if individuals and social groups do not suffer excessively high adjustment costs that would threaten the domestic social cohesion.<sup>132</sup>

Influential liberalist scholars argue that trade cooperation is a so-called two-level game, in which trade negotiators have to accommodate domestic constituents when cooperating internationally (Putnam, 1988). In the first level of the game, domestic special interest groups lobby for policymakers’ support and thereby significantly shape the second-level game outcome, in which policymakers carve out the details of international trade agreements (e.g. Grossman and Helpman, 1995a; Milner, 1998; Milner and Rosendorff, 1997; Ruggie, 1982). Helen Milner develops a model of interaction between domestic and international politics based on the assumption that states are not unitary actors but are “polyarchic” i.e. “composed of actors with varying

<sup>127</sup> Ikenberry analyses United States foreign policy after World War II in terms of an “institutional bargain” between unequal states after a war whereby “the leading state agrees to restrain its own potential for domination and abandonment in exchange for greater compliance by subordinate states” (Ikenberry, 2001: 258-259).

<sup>128</sup> This is to say, governments are assumed to be monolithic entities, endowed with a given set of preferences or values.

<sup>129</sup> See Gourevitch (2002); Milner (2002); Moravcsik (1997, 1998); Milner (1998); Downs and Rocke (1995); Evans et al. (1993).

<sup>130</sup> See Moravcsik (1997).

<sup>131</sup> On the level of methodology and research design, liberalists often use the same modelling techniques as contemporary economics, such as game theory, principal-agent models, or utility maximization concepts. Liberalist approaches to trade cooperation thereby share many properties with the political-economy approach to domestic trade policy formulation (also called ‘endogenous trade theories’; see e.g. Baldwin, 1987; Grossman and Helpman, 1994 and 2001; Rodrik 1995).

<sup>132</sup> See, for example, Corden (1997).

preferences who share power over decision making".<sup>133</sup> Milner finds that relaxing the assumption that states are unitary actors shows that even neorealists are too optimistic with regard to the possibilities of international cooperation. Domestic politics makes international cooperation always more difficult.<sup>134</sup>

When it comes to explaining the determinants of domestic trade policy preferences and the role of domestic political institutions there exists a rich body of liberalist literature.<sup>135</sup> Liberalist theories to trade agreements posit that the tug-of-war between those domestic groups that benefit from international trade cooperation (consumers, domestic and foreign exporters, using industries, importers), and those that lose from liberal trade (e.g. import-competing industries, low-skill labour, trade unions) is a highly complex, non-linear matter. The internal factors that explain which domestic group will prevail critically depends on the structure of domestic preferences, the nature and procedures of domestic political institutions, and the distribution of information internally.

A view of trade agreements as an outcome of domestic interests and politics may lead to novel insights compared to statist theories. Most importantly, new rationales for trade agreements emerge: an international trade contract may be concluded simply because one or a number of eminent special interest groups, such as domestic exporters, pressure their government into doing so (Milner, 1988).<sup>136</sup> Alternatively, a free-trade oriented government may conclude a trade agreement in order to stand up to protectionist pressure of influential domestic lobby groups. Also, a trade agreement may be a useful insurance device for voters in a democratic country who aim to control protectionist behavior of their own government (Mansfield et al., 2002; see also subsection 4 below).<sup>137</sup>

Novel rationales for trade agreements become apparent, once foreign exporters' lobby efforts are taken into consideration. They, too, may try to influence the national trade-policymaking process. Also, new motivations arise if the government is not seen as a unitary principal, but (more realistically), as different, partially competing, entities.<sup>138</sup> The picture that liberalist scholars are then describing is a trade policymaking game involving multiple agents and multiple principals:<sup>139</sup> self-interested private firms or lobby groups, who may form coalitions across countries, negotiate with self-interested public entities in affected countries over the formation of an international trade agreement. Some authors argue that this is exactly the dynamics that led to the conclusion of the GATS and TRIPS Agreements (e.g. Harms et al., 2003; Odell and Sell, 2006).

## (ii) *Focus on domestic norm generation: weakly cognitivist theories*

Theories that have been described as weakly cognitivist seek to explain how norms, values, knowledge and beliefs emerge and transcend into state decisions (Hasenclever et al., 1997: 140).<sup>140</sup> Without

<sup>133</sup> See Milner (1998: 11).

<sup>134</sup> According to the author, "cooperation among nations is less plagued by fears of other countries' relative gains or likelihood of cheating than it is by the domestic distributional consequences of cooperative endeavours". (Milner, 1998: 234).

<sup>135</sup> See, for example, Goldstein (1998). For surveys see Gourevitch (2002); Milner (2002).

<sup>136</sup> Notice the similarity between this liberalist theory and the political externality approach to trade cooperation introduced in subsection 2.(b) above.

<sup>137</sup> This rationale is reminiscent, indeed exactly congruent, to the "commitment" approach brought forth by political economists (as discussed in subsection 2.(c)).

<sup>138</sup> Clearly, different public agencies and entities pursue different interests in the national trade-making process. Legislators, ministries, government agencies, cabinet members, and heads of state may very well have conflicting interests, constraints and agendas when it comes to national trade policy-formulation. See Ethier (2001a) for an attempt to formalize domestic strategic games along those lines.

<sup>139</sup> While the idea of trade agreements as an equilibrium outcome of a game of multiple agents and multiple principals is quite intuitive, it is difficult to operationalise so as to produce testable hypothesis and predictions. Currently, the adequate methods and technical tools are wanting (see Grossman and Helpman, 2001).

<sup>140</sup> When analysing the emergence, diffusion and change of ideas, weakly cognitivist scholars have developed the concept of the "norm life cycle" (Finnemore and Sikkink, 1998). This cycle comprises of the following stages: emergence (generation of norms), cascade (domestic diffusion through socialization), and internationalisation (global diffusion through peer pressure, international organizations and/or norm entrepreneurs).

challenging the assumption of instrumental rationality *per se*, weakly cognitivist theories are compatible with the conception of states as rational utility maximisers, because they focus on the impact of ideas and knowledge on the manner in which states define their interests. However, they are also compatible with systemic theories of constructivism (the strongly cognitivist stance), since norms and values that permeate the system must accrue somewhere.

The role of ideas and knowledge in international cooperation has recently been highlighted by weakly cognitivist IR theories when discussing “epistemic communities” in the formation and evolution of international regimes. The term epistemic community has been defined in this context as “a network of professionals with recognized expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge within that domain or issue-area” (Haas, 1992: 3). One example of the application of this concept to the GATT/WTO is a study on the emergence of a “trade-in-services epistemic community” by Drake and Nicolaïdis (1992: 95) during the Uruguay Round negotiations on the GATS. The authors argue that “by framing the issues and establishing the policy options, the community provided governments with the bases on which to define or redefine their national interests and pursue multilateral cooperation”.<sup>141</sup>

Another theme in weakly cognitivist IR literature concerns the process of learning in the context of international institutions, especially learning that entails a change in a government’s perception of its interests, as opposed to simply a change in its perception of how best to realise its objectives.<sup>142</sup> There are relatively few studies that analyse GATT/WTO in terms of learning and the development of consensual knowledge.<sup>143</sup>

A final weakly cognitivist approach to international cooperation is the role of moral entrepreneurs, or eminent individuals, who influence important norms and values needed for international cooperation, and/or who crucially shape the content and structure of treaties (e.g. Finnemore, 1996; Checkel, 1998). For the case of the GATT, the salience of certain spearhead figures of liberal trade is well-documented. Various authors (Penrose, 1953; Jackson, 1969; Dam, 1970; Gardner, 1980; Irwin, 1996; Miller, 2000) have emphasized the prominent role that individuals such as John Maynard Keynes, James Meade, Lionel Robbins, and Cordell Hull have played in establishing common ground for trade cooperation and for formulating the treaty text.<sup>144</sup>

#### (d) How IR theories of trade cooperation relate to economic approaches

As was shown in this section, trade cooperation features prominently in the discipline of IR. Some IR theories are thereby very much akin to economic theories. Agent-centred, rationalist approaches to trade cooperation (i.e., the schools of neoliberalist institutionalism and liberalism) share the same methodology as economics and so their explanations for why countries conclude trade agreements are quite similar.<sup>145</sup>

<sup>141</sup> See also Lang (2006: 109). More generally Goldstein (1998: 146) argues that: “...there exists an epistemic community of economists, policy-makers, and lawyers who share a common vision about economic growth (...) This community acts as a transnational interest group, advocating trade liberalization and villainizing protectionism in their home countries. There are multiple reasons why members of a free trade epistemic community advocate trade openness (...) Whatever the origin of their beliefs, these advocates monitor government action and provide authoritative advice on the workings of the economy.”

<sup>142</sup> See Haas (1990).

<sup>143</sup> Robert Wolfe (2006) defines the development of new consensual knowledge as one of the three principal roles of the WTO and analyses the interaction between institutional design, coalitions, negotiation process and learning in the context of the Doha Round negotiations. Thus “negotiation” cannot be reduced to “bargaining” but also encompasses learning. Dupont et al. (2006) provide an important empirical analysis of learning behaviour in the context of WTO trade negotiations.

<sup>144</sup> Social cognitivists might even go farther back in history when selecting the moral entrepreneurs that shaped those beliefs of liberal trade shared among societies today: modern trade theorists arguably stand on the shoulders of such eminent figures as René Descartes, David Ricardo, John Stuart Mill, and Robert Torrens, and others. They all shaped how modern trade practitioners and scholars think about international trade.

<sup>145</sup> To recapitulate, both schools focus on achieving Pareto efficiency. This is exactly the same method applied by economics. Therefore, the divide between the disciplines of economics and IR is not always clear-cut. Many arguments listed in subsection 2 above are equally applicable to some IR approaches.

However, other strands of IR can complement economic research on trade cooperation in substantial ways. IR scholars have looked at international trade cooperation from angles that are usually ignored by economists, or which are even completely out of the current explanatory ambit of economic research. IR approaches extend economic approaches to trade agreements by linking the issue of trade with other important themes of international affairs. Issues like power and the promotion of peace and democracy widen the economic horizon. Moreover, factoring in the role of ideas, norms and values in trade cooperation sheds light on important qualitative dimensions, such as justice, fairness, legitimacy and participation. The discipline of IR shows that economic values are not the only concerns that sovereign states maintain when evaluating the merits of trade agreements.<sup>146</sup>

The discipline of international relations provides further insight into certain aspects of trade cooperation. For example, economic theories of trade agreements provide a treatment of the sub-state level that is less developed than those of international relations. Economic theory could thus be significantly augmented by incorporating perspectives from IR theory on: i) the prominent role of individuals, elites and epistemic communities; ii) the complexities of domestic competition between special interest groups; and iii) the interaction between special-interest groups and the legislative, executive and jurisdictional branch of the government. Furthermore, various IR concepts stress the impact that the system has on the individual actors. While neorealists posit that the power rank in the international system shapes countries' cooperative behaviour, constructivists claim that pervasive inter-subjective beliefs condition the choices that states make.

Finally, novel themes and additional perspectives raise various questions in connection with trade cooperation. For example: who exactly is the "state"? How does it generate its preferences and, more importantly, what changes its preferences?<sup>147</sup> Why does history matter in trade cooperation and how do actors evolve over time?<sup>148</sup> What is the pattern of bargaining and how do domestic institutions, habits, culture and religion influence actors' perceptions, learning and decision-making? In short, an approach that goes beyond analyses based exclusively on efficiency considerations suggests that when cooperating on trade matters countries are influenced by non-economic motivations, such as history, their political and social environment, and a multitude of stakeholders that act on a variety of motives.

#### 4. THE RATIONALE FOR TRADE POLICY COOPERATION FROM A LEGAL POINT OF VIEW: CONSTITUTIONAL FUNCTIONS OF INTERNATIONAL TRADE AGREEMENTS

"Legal" theories of trade agreements are based on two central insights, namely that the individual citizen is the legitimate principal in all domestic and world affairs (including trade policy), and that "government failure" and rent-seeking behaviour of public officials are rampant and need to be overcome by means of an adequate legal framework – namely a "constitution". Based on these central tenets, four legal rationales for trade agreements can be distinguished: (i) the internal constitutional view, which takes trade agreements to be the "second line" of constitutional defence against domestic policy failure; (ii) the external, or transnational, constitutional view, which perceives trade agreements to be contracts aimed at reciprocally granting countries transnational representation and participation; (iii) the internal-external constitutional view that claims that elected legislators deliberately delegate trade policy-making to the Administration; and (iv) the global constitutional view which establishes that citizens in an interdependent world enact an international multilevel trade constitution, since national constitutional approaches and state-centric international law necessarily fail to curb global policy failures.

<sup>146</sup> Reasons for not cooperating in trade affairs are thereby as significant as reasons to do so, since countries' reluctance to join needs to be anticipated, factored in, and overcome by trade negotiators.

<sup>147</sup> An example here would be the question, why Viet Nam chose to join the WTO after nearly 60 years of multilateral trading order.

<sup>148</sup> An interesting question is for example, why the GATT morphed into the much more complex treaty arrangement of the WTO over the years (on this topic, see section D.1 below).

Legal scholarship rarely examines the rationale for concluding international agreements and establishing international organizations, such as the WTO. As Schermers and Blokker (1995: 8) argue, “in the land of legal science there is no strongly established tradition of developing theories on [treaty regimes]”. Rather, legal science offers descriptive accounts of the history and institutional architecture of treaties, as well as doctrinal analysis of norms and texts, especially the normative output of organizations such as GATT/WTO panel decisions (Abbott and Snidal 1998). Not surprisingly, with one or two exceptions, international lawyers have given little attention to the question why trade agreements exist (Regan 2006, Gerhart 2003). This Section will review “legal” theories of trade agreements,<sup>149</sup> or rather, which additional insights legal scholars can bring to the discussion of the rationale of trade agreements.<sup>150</sup>

### (a) Constitutions as a corrective against policy failure

The point of departure and core of all legal theories of trade agreements discussed below is a strong focus on the individual citizen as legitimate (and oftentimes actual) political principal on the one hand, and the fallibility of political agents on the other. Lawyers maintain the perspective of “normative individualism”, in which citizens eligible to cast their vote (the *demos* or polity) – at least in democracies – are the *de jure principal* in domestic affairs. The legislative, executive and judicial branches of government are merely agents entrusted with the task of bringing policy, laws, and conduct into conformity with the desires of the majority of citizens.

Legal scholars, however, are aware of the fundamental public choice insight that rent-seeking behaviour of both elected officials (“the government”) and certain elites (special interest groups), coupled with limited oversight by parliaments, may frequently lead to government failure. De facto, government decisions on domestic policies – if unchecked – oftentimes are not so much guided by national interest as by a desire to maximize political support and to minimize political opposition. And just as domestic market failure in the domain of competition policy is contained by rules prohibiting price fixing, quantitative restrictions, market sharing and other discriminatory restraints on competition, government failure equally needs to be addressed by society. Societies customarily do this through constitutions – that is, long-term institutional arrangements of a higher legal rank that allocate lawmaking and decision-making among individuals and institutions. The basic objective of constitutions is to limit government powers, to institute a system of checks and balances, and to protect equal rights of citizens against “political expropriation” by self-interested government officials. Constitutions are thereby seen as an important means of reinforcing and maintaining basic values of democracy, individual freedom, and participation. Democracy in this framework is regarded as the best regime structure conducive to the pursuit of individual goals and as the mechanism needed for diffusing governmental power throughout society.<sup>151</sup>

Economic policy and international trade are important areas of societal activity and are especially prone to both market and government failure. Although liberal trade is considered to be in the interest of the majority of citizens (hence in the national interest), concentrated special interest groups can command disproportionate leverage over the trade policy-making process.<sup>152</sup> Legal scholars have argued that in most

<sup>149</sup> The term “legal theory” is not quite correct, since the theories described in this subchapter are not particularly legalistic. Their argumentation is not unique to the science of law. Rather, the introduced theories are lawyer’s interpretations of social interaction. Legal scholars have drawn on material from those disciplines whose research focus is the explanation of human interaction, such as economics, political science, sociology, or philosophy.

<sup>150</sup> This is of course not at all to say that international trade lawyers adhere to legal theories of trade agreements.

<sup>151</sup> In democracies, constitutionalism is “crucial to reinforcing the power of the diffuse citizenry and to restrain special interests that are “adverse to the permanent and aggregate interests of the community”. (McGinnis and Movsesian 2000: 526, quoting the Founding Father of the U.S. Constitution, James Madison).

<sup>152</sup> Owners and workers in industries that are habitually injured by freer trade tend to overcome collective action problems more easily, and manage to form coherent lobbies (e.g. Brainard and Verdier, 1994). Special interest groups are often homogenous, geographically concentrated, and can exploit nationalist sentiments against foreign import surges. Their protectionist efforts tend to overshadow the more diffuse majority concerns that favour freer trade. Consumer interests are too dispersed, their direct losses relatively small, and their information level usually relatively poor. Exporters have little representation in the polity. Importers are usually few in number, and downstream industries using imported inputs depend significantly on domestic markets and national sentiment (Milner, 1998).

societies there exists something like an “economic” constitution. The rationale for this constitution comes in two flavours that slightly differ in perspective but can actually be seen as mutually reinforcing.

Scholars from the European legal tradition – the “Grotian” or “Kantian” perspective of “European absolutism” (Pauwelyn, 2006) – take the view that every economic actor is born with a set of inalienable rights that permit him/her to be free from discriminatory competition, arbitrary taxation, redistribution and expropriation, as well as free to engage in unhampered economic exchange and enter into contracts. From this perspective, an economic constitution encroaching on governmental discretion in economic affairs is a natural way to protect basic economic rights.<sup>153</sup>

Lawyers from the Anglo-Saxon legal tradition (“Lockean” perspective of “American voluntarism”) tend to have a more utilitarian (i.e. majoritarian) approach. According to them, it is in the rational, utility-maximizing, long-term interest of the majority of market agents (and every citizen is a market agent in his capacity as consumer, producer, or trader) to limit the rent-seeking capacity of elected officials. Trade protectionism is generally domestically irrational.<sup>154</sup> To this end, citizens write a societal “contract” – a constitution – that sketches government responsibilities and devises supervisory mechanisms in the form of checks and balances between the legislative, executive and judicial branches of government.<sup>155</sup> Government agents need to feel these constitutional constraints and institutional checks and balances in order to make decisions in the “national interest”.

Whatever the rationale for a domestic trade constitution – contractarian or rights-based – freedom from protectionism, undistorted competition, and non-discriminatory economic activity is considered in the best interest of citizens. Therefore, a liberal trade policy and a clear hierarchy of domestic (trade) policy instruments emerge endogenously.

(i) ***How to overcome “government failure”: constitutionalist theories of trade agreements***

If liberal trade, non-discrimination between domestic and international economic actors, and freedom from arbitrary government protectionism are in the national interest of economic actors, why then does a system of liberal trade and free markets not emerge endogenously and spontaneously within countries? And since citizens have proven to be able to overcome collective action problems by writing national constitutions that protect their basic human and political rights – why is there any need for an international trade constitution? Four distinct rationales for international trade agreements can be detected in legal literature.

**The internal rationale – trade agreements solve a domestic problem**

The internal, or inward-looking constitutional approach to trade agreements focuses predominantly on *domestic* problems within the country that undertakes protectionist measures. In the presence of overwhelming special interest group pressure for protectionism, a trade agreement acts as an additional constitutional constraint, a “second line of constitutional entrenchment of personal rights” (Tumlrir 1985: 87). The conclusion of a trade agreement can be seen as a logical extension of the national constitution to safeguard the latter’s functioning. It operates as an international peg (or anchor) against government misdemeanour and lobby influence.

<sup>153</sup> Petersmann (2006: 56) explains the Kantian perspective on normative individualism as “values derive[d] from respect for individual self-development and from the constitutional protection of liberty and citizen-driven markets – in the economy no less than in the polity.”

<sup>154</sup> More precisely, protectionism is domestically irrational in developed countries that possess the means and institutions to address domestic problems (e.g. boost infant industries, address redistribution problems) in more efficient ways than through trade protection (see Regan, 2006, and Bhagwati, 2002).

<sup>155</sup> Proponents of the “constitutionalist” school of economics (such as James Buchanan, Gordon Tullock, Anthony Downs, Mancur Olsen) have shown how citizens overcome collective action problems, tie down policymakers’ discretion and curb the influence of government and private actors on basic freedoms.

Hence, the internal rationale of constitutionalism essentially takes a national constitution and trade agreements to be complements, whereby the international treaty fortifies a country's economic constitution.<sup>156</sup> Under this approach, a trade agreement is perceived as an international constitutional reinforcement of the national trade constitution.

But why is a national constitution not enough to curb protectionism? Why do citizens opt for an external anchor to constrain the behaviour of policymakers? A number of "domestic policy functions" of international trade rules can be found in the literature (see Regan, 2006; McGinnis and Movsesian, 2000; Petersmann, 1986):

- Trade agreements contain a rich set of rules and often feature strong sanction mechanisms against defection. Granting protectionism will therefore be more "costly" to policymakers in terms of international reputation loss, and in terms of withdrawal of support by those industries harmed by the sanctions. Rules of transparency requested in trade agreements (such as Article X GATT) make the erection of trade barriers more obvious to domestic citizens. This increases domestic "audience costs" of protection.
- External "hand-tying" is easier to monitor. For various reasons, trade policy is customarily delegated to the executive branch. However, legislative assemblies are not capable of exercising complete and permanent oversight with respect to all trade policy measures employed by the executive. An international trade agreement helps the legislative branch to exercise supervision as foreign producers and governments are constantly scrutinizing the home government's actions.
- International trade agreements trigger a domestic "pull-effect". A central feature of any trade agreement is reciprocity.<sup>157</sup> Reciprocal trade liberalization commitments create collective pressure for freer trade in each country, since the prospect of additional access to foreign markets creates incentives for domestic exporters to lobby for lower tariffs.<sup>158</sup> This adds weight to the less organized domestic free-trade camp of consumers and importers, helping to counterbalance the disproportionate impact of protectionist groups.
- In some legal systems, legislative procedures for the conclusion of a trade agreement are likely to be easier than a constitutional amendment. Therefore, citizens and free-trade-minded policymakers may prefer the "external" to the "internal" peg.
- For psychological reasons, a trade agreement based on the *do ut des* principle of reciprocity ("I give so that you give back") is simply easier to sell to domestic audiences than unilateral trade liberalization. As Regan (2006) argues, this may be irrational, but nonetheless true.<sup>159</sup>

According to Hudec (1993) and McGinnis and Movsesian (2000) an important feature of international trade agreements is that they foster democratic values and help preserve important economic freedoms without jeopardizing domestic sovereignty or legitimacy. Trade agreements like the WTO constrain harmful acts of protectionism. This not only promotes freer trade and protects opportunities for private exchange, but also strengthens accountable democratic governance by supporting the will of the majority in the face of protectionist lobbies who would otherwise capture the mechanisms of public policy. As long as trade agreements are framed in such a way that they honour the diversity of Members (in terms

<sup>156</sup> Petersmann (1986: 277) states: "The various layers of private commercial law and public national, regional and worldwide international trade law can be conceived of as a "stratified order", whose "component orders", layers and rules mutually reinforce and strengthen each other following the 'plywood principle'".

<sup>157</sup> Cf. section C.2.(a) below for an economic introduction into the nature of reciprocity in trade agreements.

<sup>158</sup> See Baldwin (1994), or Baldwin and Robert-Nicaud (2005); see also subsection 1.(a).(ii) above.

<sup>159</sup> "Even if people understand that their own protectionism hurts themselves, people are often willing to hurt themselves in order to hurt others, out of envy or a desire to punish. Or people may just fail to understand how their country's protectionism hurts themselves. The proposition that protectionism is domestically irrational is old hat to economists, but familiarity should not blind us to the fact that it is a sophisticated insight.". (Regan 2006: 967.).



of nations' development level, social system, and cultural idiosyncrasies, etc.), and as long as they respect the diversity of domestic legislation, and do not interfere with efficient regulatory competition among countries, trade agreements will not harm the sovereignty of its Membership.<sup>160</sup>

In sum, proponents of the internal constitutional approach contend that citizens manage to better tie the hands of domestic trade policymakers to the mast of liberal trade by forcing their national authorities to conclude international trade agreements. That way, both protectionist endeavours on the part of special interest groups and opportunistic rent-seeking behaviour by trade officials can be curbed successfully – without risking domestic democratic values or a loss of sovereignty.<sup>161</sup>

### The external rationale – trade agreements solve a transnational problem

An alternative perspective to the internal vision of constitutionalism is the external, outward-looking, or transnational rationale for trade agreements. The external view of constitutionalism takes issue with the internal school of thought, alleging serious conceptual shortcomings in the latter's argumentation. The critics question whether any society would ever conclude an international trade agreement for the reasons proposed by the internal constitutionalist view.

Obvious practical questions arise, such as why independent domestic institutions (like a constitutional court) are not enough to enforce the national economic constitution. Or, how multilateralism can be explained by internal constitutionalists. After all, hand-tying to a single economic super-power should suffice.

Moreover, it is argued that the internal constitutional view cannot account for the following puzzle: on the one hand, the benefits of trade liberalization are not well understood by the polity in general (Irwin, 1996; Hudec, 1993; Gerhart, 2003; Ethier, 2004). Average citizens do not seem to mind trade protection too much, partly because they often fail to grasp the (indirect) gains of trade liberalization, and partly because individual losses from trade protection are minor. On the other hand, individuals fear the (direct) costs of trade liberalization, such as sectoral unemployment, adjustment costs and social frictions. Given this reality, how can a trade agreement whose central premise is neither understood nor appreciated be chosen by the polity as a means of constitutionalism? Mavroidis (2007) also points to a circularity problem – in the face of an uninformed citizenry, why would governments ever negotiate a trade agreement if their true aim were not to maximize welfare in the first place?

Finally, a striking criticism of the domestic constitutionalist perspective is the theory's exclusive focus on economic efficiency as an explanatory variable for the conclusion of a trade agreement. As shown above, the internal view is guided by the idea that citizens wish to forestall economic free-riding by special interest groups, and therefore wish to eliminate all protectionist (discriminatory) trade policy formulation. This is achieved by pegging domestic trade policy decisions to an international agreement. Yet, the perception that protectionist trade policies exclusively result from government failure may be false. As Gerhart (2003) points out, domestic public policy is full of examples where protectionist policies are in the explicit public interest and trump considerations of short-term economic efficiency. In their pursuit of non-economic objectives or long-term interests, societies have regularly shown a preference for unequal

<sup>160</sup> McGinnis and Movsesian (2000: 549) strongly argue in favour of an "anti-discriminatory" model of trade agreements. The organization is only to act as an "adjudicative system with limited authority to resolve claims concerning discriminatory trade measures" (*ibid.* 517). The alternative "regulatory model" authorizes the organization to formulate global labour, environment, health or safety standards and other substantial trade-related areas. According to the authors, this model would be a bad form of constitutionalism, undermining national regulatory sovereignty, and exposing the organization to exactly the same lobby influence that the agreement was designed to overcome in the first place.

<sup>161</sup> Notice the similarity of the internal constitutionalist vision with that of the economic commitment approach (discussed in subsection 2.(c) above). Both schools of thought allege that trade agreements are motivated by a domestic dilemma that is solved by curbing decision-makers' protectionist discretion through international commitments. However, while the economic literature seems to assume a liberal trade stance of policymakers, legal explanations give a more thorough rationale for the hand-tying motivation: Citizens (through an unspecified mechanism) coerce policymakers to contract with other countries, because it is in the majority's interest to do so.

treatment of citizens.<sup>162</sup> For reasons of social justice, environmental or health concerns, altruism, or domestic redistribution societies may prefer protectionist trade measures. However, pegging domestic trade policy to a trade agreement, means that citizens largely give up the possibility of constitutionalizing non-economic values. This may easily clash with society's understanding of democracy.<sup>163</sup> Closely connected to this democratic deficit there may be a sizeable sovereignty deficit implicit in the internal, purely economic constitutionalist view. According to Gerhart (2003: 49) it is wrong to assume that sovereignty is designed to provide one particular outcome, such as that of maximizing efficiency or wealth. In fact, this may undercut the very notion of sovereignty, which is to preserve the right of a people to choose the outcomes that they think are best, including the desire to forego wealth in order to achieve other values. The "argument that the WTO helps bind the hands of the people so that they avoid unwise policy is, in fact, an attack on sovereignty" (*ibid.*). As the author points out, trade agreements that conflict with popular notions of participation, democracy and sovereignty must also fail on account of legitimacy. Hence, due to its exclusive focus on economic efficiency, the internal view is unlikely to explain why citizens may acquiesce to an international trade agreement.

The external legal theory of trade agreements claims to overcome the deficits in democracy, sovereignty and legitimacy that plague the internal rationale. This rationale shifts the perspective from a domestic to a transnational (cross-border) problem. Whereas the internal view is concerned with the harm a country inflicts upon itself by taking protectionist measures, the external view on constitutionalism focuses on the harmful actions of other nations that directly affect the home country.

At the core of the external view is the argument that the risk of government failure and rent-seeking are not a purely domestic problem. Thus, although undistorted competition and non-discriminatory trade policymaking remain prime objectives of trade agreements, the effects of protectionist trade barriers abroad are an issue. By raising protectionist barriers, foreign countries can strip domestic exporters of basic economic contracting rights and market freedoms.<sup>164</sup> While citizens are able to contain their own rent-seeking officials by means of a home-grown economic constitution, they have no leverage over policymakers abroad.

This reciprocal "taxation without representation" problem (Gerhart 2003: 22) can successfully be overcome if citizens authorize their governments to conclude an international treaty. Thus, proponents of the external perspective claim that trade agreements are concluded so that citizens can participate in the making of foreign countries' trade policies.<sup>165</sup> Trade agreements provide an adequate forum to address the reciprocal "problem of unrepresentative decision-making in national forums by allowing countries to represent their interests, and the interests of their people to the governments of other countries in a way that can bring about policy changes and reduce harms" (*ibid.*: 24).<sup>166</sup>

The significance of these negotiations is political as well as economic: trade agreements give rights and voice to previously disenfranchised groups of economic actors. With an agreement in place, all those citizens that are adversely affected by foreign trade policy can comment on, and influence, the policies of other countries (via their home governments). In the age of globalization and transnational exchange, trade agreements are thus a new form of democratic representation across borders. In an interconnected

<sup>162</sup> Non-economic public policy objectives may stem from important societal values such as equity, community and social cohesion, avoiding health risks, maintaining domestic peace, avoiding the infliction of pain to small numbers of people over policies that provide small benefits to everybody (Corden 1997), and so forth. Long-term economic reasons for protection include the well-known infant-industry and technology-cluster arguments.

<sup>163</sup> "The problem with the internal economic vision is that for many people, the economic or efficiency values on which it is based are only a subset of the values that make social arrangements valuable... [The] vision espouses the very caricature of the WTO that the WTO critics find so objectionable – the idea that the functions of the WTO is to freeze public policy into efficiency values, and to retard public policy that would be based on non-efficiency values." (Gerhart, 2003: 33, 70).

<sup>164</sup> This goes not only for deliberate opportunistic foreign government actions, but also for accidental spillovers. As Ethier (2001), for example, points out, many domestic policies produce unintended trade externalities.

<sup>165</sup> "The external, participatory vision of the WTO therefore sees the WTO as a complex, multiparty forum for barter between nations that allows each nation to represent the interests of its constituents to other nations, and facilitates agreements that reduce the harmful external effects of national policy." Gerhart (2003: 25).

<sup>166</sup> Note that transnational representation across borders offers protection from rent-seeking behaviour by domestic special interest groups as a side-effect – but not as a motivation – for concluding an agreement.

world, citizens can participate in shaping all those policies that concern them. Consequently, this cross-border participation promotes freedom – economic agents are granted the freedom to produce and sell where and what they want, knowing that this freedom cannot be taken away from them without their voices being heard. These fundamental constitutional values of freedom, voice, and participation are of great importance, since they foster the important concepts of federalism, sovereignty and democracy.

In sum, the external perspective not only highlights the economic inefficiency in the country imposing the tariff, but the representational, participatory deficiency resulting from protectionist policies abroad. Foreign countries' protectionism is prone to distort the competitive opportunities of citizens at home – unless the latter are given a voice in determining whether a tariff will be imposed.<sup>167</sup>

### *Internal-external rationale – self-restraint of pivotal groups*

As we have seen, the internal perspective reflects solely on domestic problems of protectionism, while the transnational, or external theory focuses primarily on participation and representation issues across borders. The internal-external rationale seeks to strike a balance between those two perspectives.

Hudec (1993) reminds us of the history of the United States Tariff Act of 1930 (better known as the Smoot-Hawley Tariff Act). As was explained in subsection 1.(b) above, this legislation originated as an effort to raise tariffs on certain agricultural imports as a way of protecting United States farmers from low world commodity prices. In order to secure the necessary votes, the Act's sponsors (Senator R. Smoot and Representative W. Hawley) engaged in a process called "log-rolling" or "horse trading" by offering to support tariff increases for other legislators' local industries in return for the latter's support for their own proposals. As is well known, the overall increases in tariffs were massive. Consequently, imports to the United States were sharply reduced. The rest of the world responded by imposing equivalent (or even more restrictive) trade barriers, causing United States exports to fall dramatically. The ensuing trade war dynamics set off a sharp contraction of world trade and contributed to the length and depth of the Great Depression of the 1930s. After the experience with the Smoot-Hawley Tariff Act, the United States Congress passed legislation that authorized the Administration to negotiate tariff reductions with other governments. The logic behind removing Congress from the decision and entrusting the Administration with formulating trade policy apparently was the following. Members of Congress were persuaded of their own ineptitude on tariff matters (Hudec, 1993: 314). They realized their inability to counter domestic interests, and feared the international repercussions that excessive protectionism may provoke. Therefore, they delegated trade policy to the Executive, which they thought was further removed from special interest group pressures.

The experience of excessive protectionism in the 1930s motivates a third rationale for trade agreements. As a matter of self-restraint, a peer-group of decision-makers (a political elite) delegates authority to a third party – namely to the Executive – in the hope that the third party will make better and more balanced decisions. The Administration, whose interests are presumably more aligned to overall national welfare, sensibly concludes an international contract.<sup>168</sup> A trade agreement is thus the natural outflow of the legislators' decision to remove themselves from the trade-policy making process.

In essence, this view combines a clear internal orientation (overcoming domestic policy failure) with an external motivation (fear of retaliation and welfare-depreciating dynamics). Legislators trade off their short-term domestic gain from protection followed by a long-term loss caused by international spillovers for the (presumably higher) long-term gain generated by the trade agreement. A "constitutionalization" of sorts (legislators' hand-tying efforts) then effectively takes place between the legislature and the executive, not between the general polity and the government.

<sup>167</sup> Notice the similarity in argumentation between this external constitutionalist approach and externality-based economic theories discussed in subsections 2.(a) and (b) above. In addition, the focus on overcoming external effects is also at the core of various IR models (see section C.3). Common to all views is the contention that international spillovers (of some nature) are what motivates the conclusion of trade agreements.

<sup>168</sup> Judith Goldstein's (1996) analysis of the US-Canada Free Trade Agreement indeed suggests that actors who have the most to gain from a pursuit of general welfare – such as executives elected by a national constituency – tend to show the most interest in turning to international agreements (see also Simmons and Martin 2002: 202).

The advantage of this view is that it can explain why trade agreements are concluded despite the obvious indifference of citizens *vis-à-vis* trade liberalization: it is not the electorate that calls for an economic constitution and a trade agreement. Rather, it is the enlightened self-interest of a political elite that motivates it to detach itself from trade policy-making and to delegate its authority to an outsider in the domestic lobbying game.<sup>169</sup> The outsider (the Administration) then concludes trade agreements not because it is forced to do so (as in the internal constitutionalist rationale), but because it is in line with its own interests that happen to be more congruent with general welfare and therefore the desires of the polity.<sup>170</sup>

### *Global rationale – trade agreements as international multilevel constitutions*

The fourth rationale for trade agreements is yet another logical extension of the idea that societies give themselves constitutions in order to maintain fundamental freedoms and to safeguard the interest of the majority of citizens. Like the external view of constitutionalism, the global rationale searches for new forms of democratic representation in an interconnected world. But whereas the previous three rationales are fundamentally state-centric, the global rationale does away with states as necessary intermediaries between the dealings of economic agents of different nations.

This “citizen-oriented constitutional view of international law” (Petersmann 1995) applies the same constitutional logic, but just assumes the world to be like one big nation of “world citizens” that gives itself a multilevel trade constitution – with the same goals of non-discriminatory competition and prevention of protectionism. The term “multilevel” means that non-state actors have legal access to domestic and international courts so as to keep governments in check, and to defend their constitutional guarantees of freedom, non-discrimination, the rule of law and social safeguard measures in case of rampant government failure (Petersmann, 2006: 6). Trade conflicts thus become depoliticized, decentralized, and replaced by constitutional rules of a higher legal rank, which can be directly applied and enforced in domestic courts.

The global view is harshly critical of both the internal and external constitutional view on trade agreements, especially because of their emphasis on state sovereignty. Proponents of the global view argue that the “Westphalian” notion of international law is outdated. State-centric “Member-driven-ness” is hostile to the vital interests of citizens.<sup>171</sup> To globalists, national trade laws on the one hand are necessarily “partial constitutions” – and of dubious quality at that. They cannot tackle global problems involving transnational spillovers, and they have frequently failed to control domestic protectionism.<sup>172</sup> On the other hand, international trade agreements between governments fail to eradicate the risk of (inter-)national government failure, for the simple reason that self-interested, rent-seeking governments negotiate the deal. In short, having governments interconnected as brokers among citizens of different countries often produces unwanted outcomes.<sup>173</sup>

<sup>169</sup> Note that the internal-external approach to trade agreements does not treat “the government” as a monolithic bloc. Executive, legislative, and judicial functions are three different, heterogeneous, and often conflicting constituents of public officials.

<sup>170</sup> Thus the Administration concludes a trade agreement of its own volition to address the problem of international spillovers caused by trade protectionism.

<sup>171</sup> “The one-sided focus of traditional public international law doctrine on external state sovereignty and no less one-sided focus of constitutional ... theories on internal abuses of power and rights of citizens within states, need to be overcome by transnational constitutional theories on how to protect ... democracy and rule of law more effectively across frontiers.” (Petersmann, 1998: 177).

<sup>172</sup> “All national constitutions remain confronted with the Lockean dilemma that, in an interdependent world with some 200 sovereign states, most constitutions provide for only few procedural constraints on discretionary foreign policy powers to tax, restrict, and regulate the transnational relations of citizens across frontiers. Thus, national constitutions turn out to be incomplete partial solutions. They don’t constrain discretionary foreign policy powers and fail to provide the collective supply of “global public goods” (Petersmann, 2006: 8).

<sup>173</sup> Petersmann (2005) speaks of a “jurisdictional gap” (the jurisdiction of a trade agreement is too limited in addressing real problems if the focus is uniquely on eradicating externalities, thus preventing the provision of true collective goods); a “democratic participation gap” (when governments negotiate the terms of an agreement, it is doubtful that the agreement grows out of representative, participatory, and deliberative democratic processes in each Member state); and an “incentive gap” (citizens as true economic actors are treated as mere objects of authoritarian trade protectionism rather than as legal subjects of a liberal world trading system).

Hence as argued by Petersmann, states are gradually losing their organizational advantage in the provision of public goods, Individual nations cannot satisfy the needs for democratic participation, legitimacy, and respect for inalienable individual rights any longer. Since trade takes place among private actors (producers, traders, and consumers) and not among governments, international law needs to guarantee private rights – which are not necessarily uppermost in the minds of governments.<sup>174</sup> Realizing this, the reasoning continues, global citizens are striving to give themselves global multilevel constitutions that manage to produce truly global public goods (the EU being a prominent example). Allegedly, this paradigm shift from the historically state-centred, power-oriented Westphalian system to a modern system of international law has finally reached the realm of world trade.<sup>175</sup> In conclusion, the global rationale for trade agreements argues that the global public bypasses national governments and manages to establish a worldwide, multilevel economic constitution.

The idea of trade agreements as international multilevel constitutions has come under criticism from international legal scholars. First, there is the seeming obliteration of a meaningful distinction between description and prescription. The global view is more about how the WTO should be, rather than what it is today. After all, in most countries, WTO law has no direct effect in the national legal system. States – even if they may be a nuisance to citizens – do exist, and in the absence of a better alternative, governments do represent nations in international trade negotiations.<sup>176</sup> Citizens, even in the most educated corners of the world, do not attach enough importance to international trade issues. Also, even concerned and enlightened private actors lack means and legitimacy to engage into global dialogues on trade constitution-making.<sup>177</sup> Second, according to critics (e.g. Howse and Nicolaidis, 2001; Cass, 2005), the global perspective dodges key conceptual questions. For example, how can the multilateral trading system be constitutionalized in absence of a *world demos*? How are global collective action problems overcome if not via national governments? And even then, how can this global constitution be changed, altered, or made to fit special circumstances and special country needs?

## (b) Comparison of different rationales

Discussion has increased in recent years on whether there is a need for legal, institutional, and political reform of the global trading system. The Director-General of the WTO, Pascal Lamy, once criticized the rule-making and decision-making processes of the WTO as “medieval”, and has called for new forms of “cosmopolitics” and “cosmopolitical constituencies” in support of global public goods.<sup>178</sup> Some legal experts see this emerging attitude towards cosmopolitics as a sign in favour of a constitutionalization of world trade affairs. All four legal rationales for trade agreements discussed above are variations and extensions of the same theme of constitutionalization. Citizens overcome collective action problems and

<sup>174</sup> “Modern international economic law is citizen-oriented and aims at limiting the traditional Hobbesian insistence on sovereign rights of governments, border controls, mercantilist protection of domestic industries and national discrimination against foreigners, which ... hinder mutually beneficial cooperation among citizens across frontiers. It is not the nation state and its national economy, but their global integration and deregulation for the benefit of individual producers, traders, and consumers that are the objective of modern international economic law”. (Petersmann, 1998: 179).

<sup>175</sup> Petersmann (2006: 33) argues “that WTO law can usefully be conceived as part of a multilevel ‘constitutional framework’ for limiting multilevel trade governance for the benefit of producers, traders, consumers and other citizens.”.

<sup>176</sup> “For Petersmann, states are a nuisance. He is welcome to think so, but he cannot ignore them. If WTO obligations were to be enforceable directly through members’ judiciaries, free traders might initially rejoice. But they would soon have to reconsider, as the dynamic effects of such a legal change took hold. For the state officials who negotiate the rules in the first place would almost surely restrict the breadth of trade agreement rules...” (Tarullo, 2002).

<sup>177</sup> Even if concerned citizens had the resources to draft a worldwide trade constitution, they would lack the legitimacy to do so unless they would represented the majority of the global electorate.

<sup>178</sup> In a lecture in 2001, Lamy, then European Commissioner for Trade, suggested that better global governance requires a system which provides for inter-connections between governments, markets and civil society. Reflecting on the globalization debate, Lamy opined that the term “governance” connotes too much control, and instead offered the term “cosmopolitics.” (Lamy, 2001; and Charnovitz, 2004).

shape rules and regulations that curb excessive rent-seeking behaviour by special interest groups and policymakers by changing the incentive structure in the political market for protection.<sup>179, 180</sup>

The four constitutional approaches to trade agreements – the domestic, transnational, internal-external and global rationale – are not necessarily in as much conflict as their respective proponents may like to claim. They contain complementary elements. However, the significance that each perspective assigns to international trade agreements as a means of constitutionalism varies in important ways. For the global view, which most directly puts the individual on centre stage, the trade agreement is the constitution. Trade agreements are a constitutional substitute for a national arrangement.<sup>181</sup> For advocates of the external perspective, a trade agreement is a constitutional supplement – it secures the international flank of economic activity.<sup>182</sup> For proponents of the internal view, the agreement is only a constitutional complement – a tool of constitutional entrenchment or a constitutional facilitator. Finally, the internal-external theory sees trade agreements as a natural outflow of a domestic constitution, in which a subset of citizens (the legislature) delegates some authority entrusted to it by the electorate to the Executive.

On a more critical note, all approaches remain unclear about how and by way of precisely which processes citizens can overcome collective action problems, thus allowing them to write a domestic trade constitution.<sup>183</sup> Given the lukewarm interest of the general citizenry to trade affairs, strong reliance on constitutional approaches to trade agreements seem a bit far-fetched. The internal-external explanation that takes trade policy-making to be a problem of elites seems more credible than the other three approaches in this respect. Next, constitutionalist theories of trade agreements seem to work only in democratic countries. Yet not all signatories of trade agreements have democratic regimes. Further, all theories except for the internal-external perspective fail to explain why governments should obey the majority will and negotiate international trade agreements that are essentially against their own interests. How can the gradual decline of trade barriers in the last 60 years of multilateral trading be explained, if trade agreements continue to be antagonistic to policymakers' preferences? In reality, state officials must have an interest in trade liberalization; otherwise they would block the progress of international liberalization rounds. Finally, common to all the legal approaches reviewed above is a certain predominance of normative overtones in relation to less than fully specified notions of democracy, sovereignty and protectionism. They tend to blur the lines between what is and what should be – that is, between analysis and prescription.<sup>184</sup>

<sup>179</sup> The internal-external view, however, has a two-level twist to this story: Citizens vote for legislators, who then constitutionalize trade policy by delegating it to the executive.

<sup>180</sup> Note that the above discussion on legal theories to trade agreements neglected contract-theoretical approaches to trade agreements originating from the discipline of law & economics (L&E). Although influential L&E scholars have suggested that there is potential for a rich research agenda in approaching the trade agreements from a contract-theoretical perspective (Bhandari and Sykes, 1998; Dunoff and Trachtman, 1999; Posner, 1988), little work on the rationale of trade agreements has originated L&E. To this day, there does not exist a thorough and systematic contractarian exploration of the world trading system. Sykes (1999: 1127) remarks: "Much like other subject areas under the rubric of international law, law and economics has only begun to make a dent in the set of potential topics in the trade area."

<sup>181</sup> It is important to point out that a trade agreement does not replace a national constitution. According to Petersmann, constitutionalism must apply on multiple levels in order to be effective. (Petersmann, 2006).

<sup>182</sup> For outward advocates, trade agreements are a *sine qua non*. Thereby, national and international constitutions are not connected in series, as two lines of constitutional defence, but in parallel. National and international constitutions protect citizens from different sides. The domestic constitution has a wide variety of objectives (including non-efficiency goals), while trade agreements constitutionalize transnational trade policy.

<sup>183</sup> As Regan (2006) aptly points out, there is no reason to believe that special interest groups which have the power to influence trade policy outcomes may not also have the power to prevent a national economic constitution or a trade agreement from being written in the first place.

<sup>184</sup> Dunoff and Trachtman (1999: 3): "International legal scholarship too often combines careful doctrinal description – here is what the law is – with unfounded prescription – here is what the law should be. This scholarship often lacks any persuasively articulated connection between description and prescription, undermining the prescription. International legal scholarship lacks a progressive research program."

## 5. DIVERSE NATIONS, DIVERSE MOTIVES, DIVERSE AGREEMENTS

Does a small, autocratic nation with weak institutions have the same motivation to engage into trade cooperation as a large, powerful, democratic country with a credible government? Subsections 2, 3 and 4 have discussed a number of economic, political, and legal approaches to international trade agreements. This subsection examines the contribution of all the reviewed theories to a better understanding of international cooperation among diverse nations. The issues tackled are whether different countries have varying reasons for entering into trade agreements, as well as how cooperation will be affected if countries have diverse motivations.

The fundamental points made here are the following. Firstly, a given explanation for entering into trade agreements does not necessarily apply equally to all countries alike, but only to a subset of countries. The decisive cooperation criteria, which differ among the various approaches, include economic size, military power, regime type, or quality of institutions. Secondly, differing motivations for entering into trade agreements are not necessarily mutually exclusive. By being large, democratic and militarily powerful at the same time, for example, a given country may be motivated by more than one reason to be part of an agreement. Moreover, owing to their diversity, countries also may conclude various types of agreements. That is, different nations have different motivations about whether to conclude bilateral, regional, or multilateral trading agreements (see also subsection 2.(d) above).

### (a) Economic perspective

Economic theory offers two coherent approaches to trade negotiations: the terms-of-trade approach and the commitment approach. These approaches are not mutually exclusive and available evidence does not shed much light on their relevance. Most other economic approaches explain exclusively preferential agreements. With regard to cooperation among diverse countries, size plays a crucial role in economic approaches, though in the commitment approach it is more the credibility of governments that is important. There are reasons to expect countries that differ on the basis of these two criteria to have different motivations to participate in trade agreements. Another important aspect of economic approaches is that, unlike other approaches, they all assume that agreements are mutually beneficial for the countries that participate.

#### (i) *The terms of trade motive*

The terms-of-trade approach provides a rationale for agreements among large countries, but for the most part fails to explain why large countries would enter into negotiations with small countries or why small countries would wish to negotiate amongst each other. A crucial assumption of the terms-of-trade approach is that countries can impose terms-of-trade externalities on their trading partners with their market access choices. Countries that are too small to influence the price of foreign exports are expected unilaterally to make trade policy choices that are internationally efficient, since they are not motivated by international cost-shifting. Such countries are less likely to end up in terms-of-trade prisoners' dilemma situations where they can benefit from trade agreements.

The nub of the issue, then, is whether a country has or does not have market power. As discussed in subsection 2 above, theoretical work by Gros (1987) suggests that with differentiated products, even small countries may have some market power. Empirical evidence on this particular issue is clearly needed. The recent study by Broda et al. (2006) is an interesting start.<sup>185</sup>

While the terms-of-trade theory has difficulties explaining trade negotiations involving small countries, it provides a rationale for their participation in the GATT/WTO. Membership in the GATT/WTO entails MFN treatment from other Members. Without MFN, a small country may be hurt by GATT negotiations

<sup>185</sup> See subsection 2 above.

if it ends up on the receiving end of discrimination. For small countries who are not granted MFN status, accession to the WTO would thus be a way to avoid discrimination.

In theory, large countries should not restrict MFN treatment exclusively to GATT/WTO Members. As explained in Section C below, if two large countries do not extend the benefit of their bilateral deal to any third country through some form of most-favoured-nation treatment, they run the risk of seeing the benefits of their agreement eroded by “bilateral opportunism”. One of the signatories can enter into another agreement with a third party that reduces the value of the initial reciprocal commitment made to the other signatory. Large countries would thus be expected to grant MFN treatment to all other countries. Available evidence, however, suggests that Members do sometimes discriminate against non-Members.<sup>186</sup> Also, even if Members extend MFN treatment to non-Members, they have the possibility of raising their tariffs above MFN levels at any time. Moreover, Members could in principle – and in some cases do – discriminate against non-Members by using instruments such as quantitative restrictions that they would not be allowed to use against other Members.<sup>187</sup> A practical question here is how pervasive such behaviour is likely to be. A theoretical question is whether large countries would see any reason to discriminate against smaller ones if the latter cannot affect world prices.<sup>188</sup> Even if economic logic dictates non-discriminatory behaviour in such instances, perhaps politics plays differently.

The terms-of-trade theory suggests that while small countries may lose if they do not participate in the system, they may not derive benefits from trade negotiations between large countries – that is, reciprocal liberalization among larger countries may not entail positive spillover effects for smaller countries. The terms-of-trade model suggests that the GATT provides a negotiating environment where large countries can internalize most of the benefits from their agreements. More precisely, if two large countries A and B reduce their tariffs on a reciprocal and non-discriminatory basis, there are no, or very limited, spillovers for third countries. The reasoning is as follows. When A and B negotiate non-discriminatory tariff reductions on a reciprocal basis they do two things. First, A and B open up their domestic markets to new imports from each other or any other country. Second, through tariff reductions A and B improve the competitiveness of their exports, which are therefore better placed to exploit the additional market access offered by each other. If the tariffs are reduced on an MFN basis, trade deviation is avoided. If a third country C does not reduce its tariffs, which could be the case for a small country, it should neither be affected negatively nor positively by A and B’s reductions.<sup>189</sup> Also, if C is a small non-Member country that receives MFN treatment, this suggests that it may not have a strong incentive to join.

To conclude, according to the terms-of-trade theory, the motivation for entering into trade agreements depends on whether a country can or cannot influence the price of its imports through its trade policy. How many countries are small according to this definition, however, is not clear. Large countries with market power can derive benefits from a trade agreement. This agreement should be multilateral rather than preferential, but because Members sometimes discriminate against non-Members, small countries have an incentive to join the agreement.

### (ii) *The commitment motive*

The commitment approach does not segment countries along the market power criterion, but along the quality of domestic institutions. The theory clearly bears some relevance for countries with weak governments. Governments with credibility problems may use international trade agreements to push through trade reforms. The trade agreements could be bilateral, regional or multilateral as long as they

<sup>186</sup> See recent WTO Trade Policy Reviews of Canada, the EU, Japan and the United States, for examples of discriminatory treatment of non-WTO Members.

<sup>187</sup> The EU has historically imposed import restrictions on footwear, tableware and kitchenware from China, and several countries impose quantitative restrictions on non-WTO Members for foreign policy reasons.

<sup>188</sup> See Staiger (2006).

<sup>189</sup> Bagwell and Staiger (2002, 2005) show that for an interesting class of trade patterns across countries, if countries A and B negotiate lower tariffs according to the principles of reciprocity and non-discrimination, then country C experiences no changes in its terms of trade.



provide a credible threat that other participants will retaliate if a participant violates its commitment. The commitment approach, however, does not explain why a country without a credibility problem may wish to enter into an agreement with a country that faces a credibility problem. Neither does it explain reciprocal negotiations to reduce tariffs. For instance, it may explain why a country joins the GATT/WTO, but not why it would need reciprocal negotiations to reduce its tariffs. Once a Member, a country could unilaterally commit to reduce its tariff.

### (iii) *Other motives for cooperation*

As seen in subsection 2, countries may want to cooperate on trade issues because they need to increase their market size. This argument, which for obvious reasons mainly applies to small countries, explains both their cooperation with large countries and cooperation among a certain number of small countries. Smallness, defined here in terms of market size rather than in terms of market power, can be a disadvantage because the domestic market may not be sufficiently large to generate the sales necessary to cover costs. Acquiring access to a large market can provide firms in the small country with the opportunity to exploit economies of scale, thus reducing their production costs and allowing profitable production.

Since, for a large country, market access to a small country is not a crucial motive for trade cooperation, the argument above does not explain why a large country would accept to cooperate with a small country. A plausible motivation for this may be the interest of the large country in cooperating on issues other than tariffs, such as environmental standards or intellectual property rights.

Related to the market size argument is the idea that a trade agreement can help attract foreign direct investment (FDI). This argument mainly applies to small and developing countries. Small countries may have an incentive to have access – especially preferential access – to the market of a large country to increase their attractiveness to foreign investors. Alternatively, they may create a free trade area among small countries for the same reason.

Another rationale for trade cooperation that has been discussed in subsection 2 above is the insurance motive. This argument mainly applies to smaller countries. And it may best explain the emergence of a number of regional trade agreements where a large country is the hub and the small countries are the spokes. This is because when a preferential arrangement is formed between a large and a small country, small countries outside the agreement will be interested in preserving their access to the market of the large country. Therefore, they will have an incentive to form a competitive preferential arrangement with the same or another large country. Alternatively, they may choose to push toward multilateral liberalization in order to recreate a level playing field among small countries in terms of their access to the markets of large countries.

Furthermore, trade cooperation among countries can be explained by the need to increase their bargaining power in the context of negotiating agreements with large (especially developed) countries. This argument mainly applies to cooperation among small countries, rather than between a small and a large country or between large countries, as large market size *per se* provides significant bargaining power. But it can also explain cooperation between a large developing country and small developing countries.

Finally, there is no specific reason to believe that protectionist motives apply differently to small and large countries. On the contrary, the role that these motives play as factors for trade cooperation are likely to depend on whether countries are neighbours, and whether their governments are sensitive to lobby pressures of organized groups.

## (b) International relations perspective

This subsection examines how the four “grand theories” of IR discussed in subsection 3– namely neorealism, neoliberal institutionalism, liberalism, and constructivism – help in understanding international cooperation among diverse nations. How can national differences in power position, size, development level, and regime type account for differences in state preferences and expected cooperative behaviour?<sup>190</sup>

### (i) *The neorealist school*

In the neoliberal conception, countries predominantly care about national security, military capabilities and the distribution of power within the international system. International cooperation is believed to occur in the form of short-term alliances or blocs. For neorealists, cooperation in trade mainly pursues two goals (Hirschman, 1980): a domestic supply effect (trade inputs and efficiency gains can be converted into military power), and a foreign policy influence effect, by which powerful countries try to create dependence. They attempt to force smaller countries into trade “cooperation”. Small countries either decide to “bandwagon”, that is, to take sides with a hegemonic state in the hope of slipping under the latter’s security umbrella and to flourish economically. Alternatively, small powers choose the strategy of “counterbalancing” by forming a power block with other rivals. Thus, neorealists would expect military and economic bloc-building to go together. Preferential trade agreements among military allies would generally be the rule.<sup>191</sup> Within this framework, the early GATT can perhaps be seen as a strategic complement to NATO by the United States and the United Kingdom in an attempt to bind parts of Europe and Latin America into the Western Bloc (Grieco and Ikenberry, 2003). The depth and breadth of a trade agreement would thus seem to depend on the dynamics of the contemporary global balance of power.<sup>192</sup>

Post-classical realists (authors like Stephen Krasner, Robert Gilpin, or Charles Glaser – see Brooks, 1997) have a more nuanced view on the power dimension. They argue that power is not an end in itself but a means of achieving security and increasing the resource-base of a country. Also, post-classical realists point to the different facets of the concept of power.<sup>193</sup> For proponents of this view, trade cooperation can reduce the probability of conflict, help overcome international externalities, foster national security, and increase the welfare base of a country.<sup>194</sup> Therefore, trade agreements should be in the interest of small and big, developing and developed, democratic and autocratic countries alike. However, since economic gains can eventually be transformed into military gains, every nation should closely watch ascendant powers. Established (regional or global) powers should exclude rising nations from a trade

<sup>190</sup> The discussion of these four traditional schools of IR is intended to be illustrative rather than exhaustive. The treatment is inevitably somewhat stereotypical and at times simplifying. The schools identified are general clusters of theoretical IR reasoning and a number of IR scholars freely straddle or draw selectively from more than one approach.

<sup>191</sup> Gowa (1989) and Gowa and Mansfield (1993) argue that because of security externalities, free trade agreements are more likely to occur within than between military alliances and that alliances are more likely to evolve into free trade coalitions in a bipolar than in a multipolar system. Gowa and Mansfield (2004) argue that alliances promote trade between states and that this effect is stronger in the case of trade subject to increasing returns to scale than in the case of trade subject to constant returns to scale.

<sup>192</sup> The depth of a trade agreement refers to the size of *ex ante* trade liberalization commitments, whereas the breadth reflects the number of sectors and issue areas covered by the agreement.

<sup>193</sup> The contemporary concept of power in IR is not to be equated to military capability or market size. Although economic market size is often seen as one of the principal sources of power in the context of international trade (see for example Barton et al., 2006:10-11), IR theory has drawn attention to the multifaceted nature of power. In their book Michael Barnett and Raymond Duvall analyse different dimensions of the concept of power as used in contemporary IR. The authors distinguish between compulsory and institutional power, on the one hand, and structural and productive power, on the other. Compulsory and institutional power work through “interaction of specific actors”, while structural and productive power work through “social relations of constitution.” This typology encompasses both power involving material resources, and power involving “ideational” resources (Barnett and Duvall, 2005). Gregory Shaffer has analysed the operation of two of these forms of power – compulsory and institutional power – in the context of the WTO (Shaffer, 2005). On different approaches to power in IR theory see, for example, Baldwin (2002).

<sup>194</sup> Post-classical realists interpret the notion of the term “security” more broadly than neorealists. For them, security encompasses an array of “new security issues”, such as conflicts due to scarce resources (e.g. water), refugees, migration, or pollution. Thus, trade agreements touching on those issue areas, especially RTAs, may gain special importance in international cooperation. (Ravenhill, 2005).

agreement, or strive to bind the latter into the trading system tightly enough for military confrontation to be perceived as too costly for all parties involved. Consequently, countries can either be expected to form trade-and-security alliances (blocs), or follow the (more risky) route of tight-knit multilateralism.<sup>195</sup>

How does hegemonic stability literature deal with trade cooperation among diverse nations? By default, this theory assumes two types of countries – a hegemon and the rest of the world. To bind other countries, but also to prevent free-riding, the hegemon is keen on creating a global trade institution that commits as many countries as possible. The bulk of small countries – independently of development level or regime type – are willing to join if the hegemon can credibly ensure that it will not opportunistically exploit the trade regime, and that the small players can actually reap the promised gains from trade cooperation.<sup>196</sup> The breadth and depth of trade commitments would thus seem to depend on the hegemon's level of ambition, as well as credibility regarding its willingness to act in the global long-term interest.

### **(ii) The school of neoliberal institutionalism**

As discussed in subsection 3.(b), neoliberal institutionalists assume that interests shape power and not vice-versa, as neorealists seem to contend. Their theories focus on actors' interests in utility maximization and efficiency rather than the power dimension. Nations' concerns regarding absolute gains among cooperating parties outweigh mercantilist concerns about relative gains.

Cooperation in trade among diverse nations, therefore, will take place irrespective of size, economic power, development level, or political regime type. As long as the expected efficiency gains from cooperation outweigh the estimated costs of establishing and maintaining the cooperation regime, nations will engage in trade agreements. Consequently, whether countries prefer bilateral, plurilateral, or multilateral trade cooperation depends very much on the initial context (for example, which market imperfections need to be resolved), the negotiating environment (how many parties are involved, and what are signatories' information levels), the costs of writing the respective "trade contract", and the expected gains of continued cooperation.<sup>197</sup>

### **(iii) Liberalist approaches to trade cooperation**

Scholars of liberalism open up the black box of domestic politics. Trade agreements are concluded if the decision to cooperate is the equilibrium outflow of some rational domestic deliberation process involving various non-state stakeholders and government entities. It is important for proponents of liberalism to stress that every country is unique due to its idiosyncratic domestic set-up. In an attempt to explain countries' rationale for entering into a trade agreement, it is therefore considered inadequate to lump countries together and to label them "developing", "small", "democratic", etc., precisely because the risk of overlooking striking differences is too large.

For liberalists, the economic size of a country does not *a priori* predetermine its trade stance. Neither does income distribution or average income level, the industry structure, the number of citizens, the level of education, the political processes, or the political regime type. Those factors are all part of the domestic context – that is, the present set-up of constraints and restrictions that have to be taken into account by those groups of society who have a liberal trade stance. If free traders want to prevail in the national trade-making process, they need to hold sway over protectionist factions in the national

<sup>195</sup> On the general relationship between military alliances and global trade patterns, see for example Gowa and Mansfield (2004) and Mansfield and Bronson (1997).

<sup>196</sup> Although the question does not feature prominently in the literature, the same concept may apply to regional hegemons. Applying the logic of hegemonic stability theory, those regional powers are likely to opt for regional trade integration. However, within its orbit of influence, the local hegemon will strive to bind all countries.

<sup>197</sup> It seems that with growing complexity in trading relations, multilateral trade deals may be superior to a decentralized web of bilateralism because of transaction cost efficiencies (Abbott and Snidal, 1998). Yet increased contractual complexity also means higher costs of pre-contractual bargaining (Fearon, 1998). Rational states hence must trade off the expected costs and benefits of choosing bilateral, plurilateral, or multilateral options for trade cooperation.

decision-making process, whatever the obstacles and stumbling blocks may be. Thus, factors making up the domestic context like regime type, the level of corruption, and political processes do matter in the sense that they positively or negatively affect the bargaining position of national pro-trade influences (e.g. Odell, 1990).

#### (iv) *Constructivist approaches to trade cooperation*

According to constructivist thinking, states cooperate and create institutions that shape and constrain state interests and behaviour. To constructivists, however, more important than the question why states cooperate is the question why states want to cooperate in the first place. Here, the roles of moral entrepreneurs and epistemic communities are salient from the actor side (“local effects”). Some charismatic individuals or influential elites may change public perception around the globe (Karl Marx or the Club of Rome may come to mind). However, systemic stimuli (“global effects”) impart social meaning and help construct international norms. Examples here are norms of international security, the promotion of peace, the rejection of piracy, genocide, or slavery, and the creation of a fair and liberal international trading order.

Applied to the realm of international trade cooperation among diverse nations, this means that countries (or rather: polities) that cherish the concept of freer and less regulated international trade will want to team up with like-minded societies in order to form a trade agreement.<sup>198</sup> Within this analytical framework, country size, population size, economic power, regime style, geography and other factors take a back seat. What counts is the degree of a society’s commitment to a more liberal international economic order.

#### (c) Legal perspective

Subsection 4 reviewed “legal” approaches to trade agreements. The four approaches – termed the internal, external, internal-external and global constitutional views – are all variants of the same theme of constitutionalism. It is polities, or societies, who are cognizant of the global phenomenon of rent-seeking behaviour among self-interested trade-policymakers. In an attempt to overcome rampant policy failure in the realm of trade policy, societies conclude international trade constitutions.

What role does diversity among nations now play for legal theories of trade agreements? From a legal vantage point the precondition for concluding any sort of trade agreement seems to be the presence of a democratic regime. All legal theories reviewed above crucially depend on the assumption that citizens have the legal means to congregate, discuss, and eventually coerce their policymakers into concluding a trade agreement (e.g. by voting recalcitrant politicians out of office). Without a handful of basic principles usually connected to a democratic regime, constitutionalism is not possible: rule of the people, the provision of basic political rights to citizens (freedom of assembly, freedom of speech, freedom to vote), and a functioning rule-of-law (separation of powers, low level of corruption, functioning and impartial court system) are the bare necessities for constitutionalism to work. Other domestic factors, such as a certain level of subsistence and education, as well as sufficient access to information seem to be crucial.

Hence, it seems that legal perspectives to trade agreements would predict that it is mainly democratic, informed, well-to-do societies who have the means to conclude trade agreements among each other. Autocratic regimes can only be expected to join if they are big enough to cause externalities to those democratic countries that have the means to coerce the former into acceding (this of course only goes for the external and the internal-external constitutionalist views).

<sup>198</sup> Societies may appreciate trade liberalization for a number of reasons: the promotion of peace, religious reasons, economic stability and growth, increases in welfare, reasons of fairness or justice, and so on.

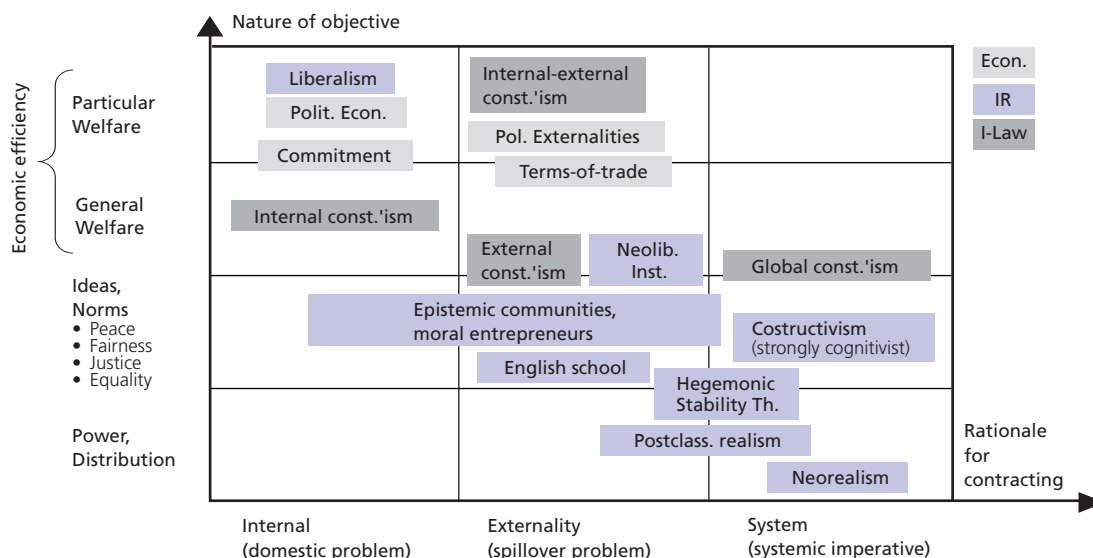
## 6. CONCLUSION: HOW TO MAKE SENSE OF THE VARIOUS RATIONALES FOR TRADE COOPERATION

This Section has reviewed economic, international relations, and legal approaches to trade agreements. The overarching objective was to explain what motivates sovereign countries to engage in bilateral, plurilateral, or multilateral trade agreements. This final Section provides a number of conclusions by synthesizing elements from all three approaches.

Before proceeding to compare similarities and differences between the various explanations for trade cooperation offered by the three disciplines, it is pertinent to stress the relevance of this analysis in the first place. Why should we care about explaining the underlying rationale of trade agreements? Three important reasons justify this endeavour. First, the motivating factors of a contract such as an international trade agreement crucially determine its nature. Treaty design – the design of contractual rules, provisions, procedures, and organizational features – is shaped fundamentally by the underlying goal(s) pursued by the contracting parties (Section C below will broach the issue of treaty design). Second, possessing a coherent understanding of the nature of an agreement is a prerequisite for engaging in any argument about the quality of outcomes engendered by that agreement. The rationale of a trade agreement is the logical yardstick against which to measure its success.<sup>199</sup> Third, dispute settlement panellists or Appellate Body Members are obliged to consider, together with the ordinary meaning of the terms used, in their context, the purpose of a trade agreement when interpreting the treaty. This is so because, by virtue of Article 31 of the Vienna Convention on the Law of Treaties (VCLT), a treaty interpreter must take into account the object and purpose of the agreement.<sup>200</sup>

How can one make sense of the various trade cooperation rationales that this Section has provided? How do the various approaches to trade agreements originating from the disciplines of economics, IR and international law differ? In what respects do they reveal similarities? Chart 1 graphically represents likeness and differences of the rationales for trade cooperation discussed above along two dimensions.

**Chart 1**  
**Comparing rationales for trade agreements**



Note: The abbreviation "const.'ism" stands for "constitutionalism", "Neolib. Inst." for "neoliberal institutionalism". "Polit.Econ." is the abbreviation for political economy approaches to domestic trade-policymaking (see section B.2.(b) and (c), and C.3.(c)).

Source: Compilation by the authors.

<sup>199</sup> Any scholar criticizing efficiency or effectiveness of a trade agreement, and/or laying out an agenda for reform should reveal his or her understanding of the treaty's central objectives. Failure to do so may mean that the agreement is discussed in a logical vacuum.

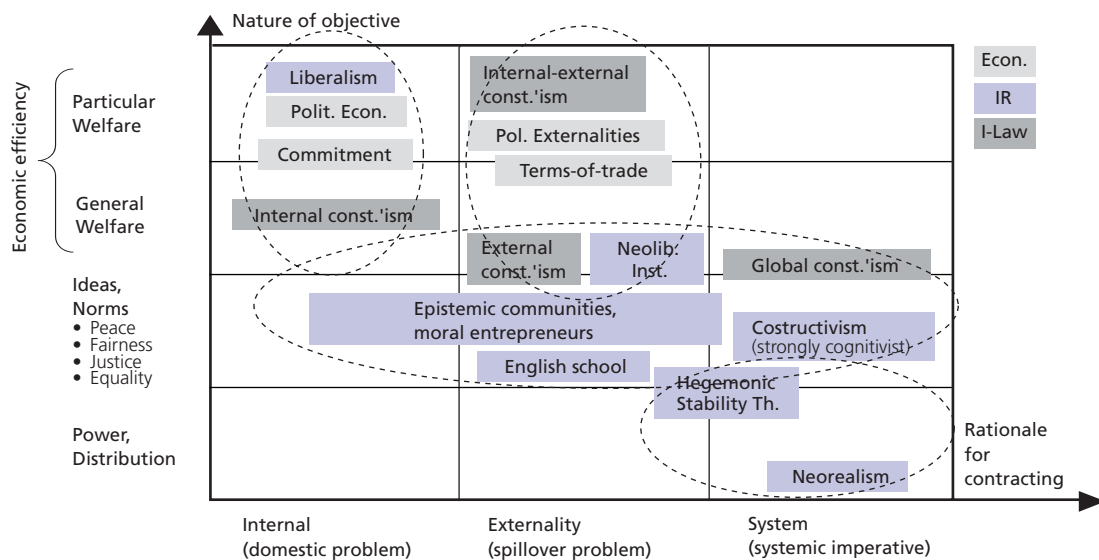
<sup>200</sup> According to Art. 31 VCLT, together with the context, any subsequent practice or agreement relating to the same subject matter, as well as any other relevant rule of public international law applicable between the parties should also be taken into account.

The vertical axis represents the “nature of objective” that is pursued by the trade contract. The horizontal axis represents the “rationale for contracting”.<sup>201</sup> It is along the horizontal “rationale for contracting” dimension where the similarity between economics, IR and international law is most striking. Approaches from all three disciplines either postulate some kind of domestic (internal), or externality-based (spillover) problem that an international trade contract can help to overcome. In addition to that, a number of IR and legal schools of thought allege some form of systemic imperative for contracting. There, the international context, or the nature of the system impels states to act cooperatively in trade affairs.

However, the different approaches in economics, IR and law vary strikingly in their explanation of why countries may wish to cooperate in the first place. Whereas (political-) economic theories assume that actors are motivated by economic efficiency concerns of a particular sub-set of society (lobbies, policymakers, consumers), or of society at large (general welfare), other approaches to international cooperation put objectives other than economic efficiency centre stage. Some IR schools allege that actors are motivated by the pursuit of military power, or a country’s power rank in the international system. Alternatively, some legal and IR explanations claim that non-economic idea-based or ideal-based factors, such as the pursuit of equality, fairness, or peace motivate countries to enter into cooperation in trade affairs.

Hence, the picture that emerges (and that Chart 2 presents visually) is the following:

**Chart 2**  
**Clustering rationales for trade agreements**



Note: The abbreviation “const.’ism” stands for “constitutionalism”, “Neolib. Inst.” for “neoliberal institutionalism”. “Polit.Econ.” is the abbreviation for political economy approaches to domestic trade-policy-making.

Source: Compilation by the authors.

One way to group the various explanations for trade agreements is illustrated by the dashed-line sets in Chart 2. We distinguish four – partially overlapping – clusters of explanations for why countries may wish to cooperate in trade affairs. Moving from top left to bottom right, the first cluster posits a purely domestic problem that negatively affects economic efficiency considerations within a country, and that an international contract can help to overcome. The IR school of liberalism, the legal internal constitutionalist view, and political economy and commitment approaches originating in economics are all variations of this theme.

<sup>201</sup> It is important to realize that the “rationale for contracting” and the “nature of objective pursued” are two distinct issues. The former is about the contractual intent in answer to the question: “what problem can a contract solve?” or “what situation can the conclusion of a contract improve upon?”. The latter is about the objective that guides actors’ decisions. It answers the question: “what do we want to achieve by cooperating?”.

The second cluster of explanations views some kind of international economic spillovers as the key problem that a contract can remedy. Trade agreements are thus concluded in order to constrain unilateralism, since one country's actions can harm the economic well-being of other countries. An international contract can successfully mitigate these beggar-thy-neighbour problems. This basic insight is at the core (with some variations and extensions) of the external and internal-external constitutionalist legal approaches, the IR school of neoliberalist institutionalism, and the terms-of-trade and political externalities theories in the field of economics.

The third cluster of trade agreement motivations can be called the "ideational route". According to scholars in this cluster, it is non-economic, normative objectives that guide the actions of trade policy decision-makers. In so far as economic or power rationales cannot satisfactorily explain why child, slave and prison labour, human trafficking, or dealing with drugs are repugnant concepts, economic thinking cannot fully explain why trade agreements are concluded. Basic civilizing norms and values, age-old traditions, a collective sense of history and humanity, and other ideational factors inspire influential individuals, pivotal groups, and states as a whole to conclude trade agreements. As was pointed out in subsection 5 above, ideational factors motivate countries to welcome even small and economically insignificant countries into the circle of participants. Non-economic objectives for contracting parties play a crucial role in the legal approaches termed external and global constitutionalism. In the realm of IR literature, ideational elements can be found in neoliberal institutionalism, hegemonic stability theory, and idealism, but especially in weakly and strongly cognitivist schools of constructivism.

The final cluster can be termed the "realpolitik" argument. Countries conclude trade agreements – or refrain from doing so – for reasons of power and subsistence (i.e. distributive efficiency). To paraphrase Clausewitz, for proponents of the power rationale of trade agreements, trade cooperation is a continuation of politics by other means.<sup>202</sup> Hence, states enter into trade cooperation, because they are coerced into doing so, or in order to seize a distinct power-related benefit from doing so (creation of dependency, balancing, bloc-building, etc.). This concern for power and distribution is most notably at the core of the IR school of neorealism, but also of postclassical realism, and hegemonic stability theory.

The fact that there are so many different theories explaining the same outcome, namely the conclusion of international trade agreements, raises the reasonable doubt that there is one single theory that is able to explain the phenomenon of trade cooperation. The discussion in subsection 5 concerning the impact of diversity among nations on their likelihood of concluding different trade agreements further strengthens the contention that the formation of trade agreements is a mixed-motive game.<sup>203</sup> A mixed-motive game has an internal and an external dimension to it. First, any country is probably motivated by an array of (partially conflicting) economic and non-economic objectives that it wants to pursue by contracting to a trade agreement. It may wish to promote peace and stability in its region, to propel its power rank in the international system, to attract FDI, to mitigate the influence of special interest groups, or to stop trade partners from engaging in excessive beggar-thy-neighbour policies, and so forth. Second, signatory countries can be expected to be quite heterogeneous in their contracting goals. Different countries are likely to possess idiosyncratic sets, or bundles, of trade cooperation objectives.

Among the conclusion that can be drawn from the above discussion are, first, that scholarship has a long way to go before a holistic explanation for trade agreements is established. Whilst current economic, political, and legal explanations seem to be able to elucidate facets of the cooperation game, they are

<sup>202</sup> Carl v. Clausewitz's original dictum of course reads: "War is a continuation of politics by other means." (See Clausewitz, 1993).

<sup>203</sup> Conceiving of trade agreements as a mixed motive game among sovereign countries, however, is not a conclusion, but a theory. Nothing in the previous analysis of this Section can disprove possible contentions that there is one single dominant rationale for concluding international trade contracts.

far from capturing the whole picture. Cross-disciplinary work seems a fruitful and promising avenue for future research.<sup>204</sup>

Secondly, given that every signatory country is likely to possess a uniquely weighted set of cooperation motives, the initial balance of the trade deal (the common consent indispensable for the conclusion of any contract) can be expected to be difficult to identify and specify comprehensively. In addition, unforeseen environmental changes, dynamism, future shocks, and all other factors having an impact on the original contractual balance evidently increase the inherent complexity. Thus, the initial trade agreement must be seen as a necessarily incomplete contract (see Section C) for further discussion of this point). Two consequences immediately follow from contractual incompleteness. On the one hand, trade agreements are far from perfect contracts and thus dependant on the continuing goodwill of all signatories. A common sense of direction and conduct must be present at all times.<sup>205</sup> On the other hand, disputes in trade affairs are an inevitable result. Incompleteness leaves ample room for ambiguity, controversial interpretations, misunderstandings, and opportunism. In order to make an agreement better and fitter for the future, signatories should embrace disputes as mechanisms to clarify ambiguous treaty language and trade policies. As long as they do not threaten the contract itself, disagreements may be seen as a sign of a system at work, not of a system at fault.

Thirdly and finally, the observation that states have heterogeneous reasons for cooperating via trade agreements should be reflected in the ongoing design of trade negotiations and the conduct of trade relations. Trade negotiators should be aware of the fact that different countries enter trade deals for different and perhaps unique reasons. Moreover, mindfulness of the diversity of motivations for trade cooperation facilitates better understanding of each country's stance with respect to trade policy and trade policy negotiations.

<sup>204</sup> An example of potentially fruitful interdisciplinary work arises from the possibility of adding further clarity to the objective functions of economic agents as surmised by economists. Economic approaches to trade agreements hypothesize that agents rationally maximize their utility. For simplicity's sake, standard theory assumes that economic efficiency (usually a maximization of income) is the best proxy for utility. Legal and IR approaches could help expand that view and integrate non-economic preferences (such as peace, fairness, equality, legitimacy, etc.) into the economist's utility function.

<sup>205</sup> The common intention of all parties is usually reflected in the preamble of a treaty, albeit at a level of generality that makes it difficult to consult the preamble when interpreting various instruments or provisions. Still, preambular language oftentimes can be seen as the smallest common denominator – i.e. the hard core of contractual intent.



## BIBLIOGRAPHY

- Abbott, K. and Snidal, D. (1998) 'Why States Act through Formal International Organizations', *The Journal of Conflict Resolution* 42, 1: 3-32.
- Adler, E. (2002) 'Constructivism in International Relations', in Carlsnaes, W., Simmons, B. and Risse, T. (eds) *Handbook of International Relations*, London, Thousand Oaks, New Delhi: Sage. pp. 95-118.
- Aggarwal, V. K. and Dupont, C. (1999) 'Goods, Games and Institutions', *International Political Science Review* 20, 4: 393-409.
- (2004) 'Collaboration and Coordination in the Global Political Economy', in Ravenhill, J. (ed.) *Global Political Economy*, Oxford: Oxford University Press. pp. 28-49.
- Andriamananjara, S. and Schiff, M. (1999) 'Regional Groupings Among Microstates', *World Bank Policy Research Working Paper Series* No. 1922, Washington, D.C.: The World Bank.
- Bagwell, K. (2007) 'Remedies in the WTO: An Economic Perspective', mimeo.
- Bagwell, K. and Staiger, R. W. (1999) 'An Economic Theory of GATT', *American Economic Review* 89, 1: 215-248.
- (2001) 'Strategic Trade, Competitive Industries and Agricultural Trade Disputes' *Economics and Politics* 13, 2:113-28.
- (2002) *The economics of the world trading system*, Cambridge: MIT Press.
- (2005) 'Multilateral negotiations, bilateral opportunism and the rules of GATT', *Journal of International Economics* 67: 268-294.
- (2006) 'What Do Trade Negotiators Negotiate About? Empirical Evidence from the World Trade Organization', *NBER Working Paper* N. 12727.
- Bairoch, P. (1976) *Commerce extérieur et développement économique de l'Europe au XIX siècle*, Mouton, Paris La Haye: Écoles des Hautes Études en Sciences Sociales.
- (1989) 'European Trade Policy, 1815-1914', in Mathias P. and Pollard S. (eds), *The Cambridge Economic History of Europe*, Volume VIII, The Industrial Economies: The Development of Economic and Social Policies, New York: Cambridge University Press. pp. 1-160.
- Baldwin, D. A. (2002) 'Power and International Relations', in Carlsnaes, W., Simmons, B. and Risse, T. (eds) *Handbook of International Relations*, London, Thousand Oaks, New Delhi: Sage. pp. 177-191.
- Baldwin, D. A. (ed) (1993) *Neorealism and Neoliberalism: The Contemporary Debate*, New York: Columbia University Press.
- Baldwin, R. E. (1985) *The Political Economy of US Import Policy*, Cambridge, Massachusetts: MIT Press.
- (1987) 'Politically Realistic Objective Functions and Trade Policy', *Economic Letters* 24: 287-90.
- (1994) 'Towards an Integrated Europe', London: CEPR.
- (1996) 'The Political Economy of Trade Policy: Integrating the Perspective of Economists and Political Scientists', in Feenstra R. C., Grossman, G. M. and Irwin, D.A. (eds) *The Political Economy of Trade Policy*, Cambridge: The MIT Press.
- (2006) 'Multilateralising Regionalism: Spaghetti bowls as building bloc on the oath to global free trade', *The World Economy* 29, 11: 1451-1518.
- Baldwin, R. E. and Forslid, R. (2004) 'Trade Liberalization with Heterogenous Firms', *CEPR Discussion Papers* 4635.
- Baldwin, R. E. and Robert-Nicoud, F. (2005) 'Juggernaut Model – The Lego Version', mimeo, GIIIS.
- (2006) 'Protection for Sale Made Easy', *CEPR Discussion Paper* 5452.

- Baldwin, Richard. E. and Baldwin, Robert. E. (1996) 'Alternative approaches to the political economy of endogenous trade liberalization', *European Economic Review* 40: 775-782.
- Baran, P. A. (1967) *The Political Economy of Growth*, New York, NY: Monthly Review Press.
- Barbieri, K. (1996) 'Economic Interdependence: A Path to Peace or a Source of Interstate Conflict?' *Journal of Peace Research* 33, 1: 29-49.
- (2002) *The Liberal Illusion, Does Trade Promote Peace?*, The University of Michigan Press.
- Barbieri, K. and Schneider, G. (1999) 'Globalization and Peace: Assessing New Directions in the Study of Trade and Conflict', *Journal of Peace Research* 36(4), Special Issue on Trade and Conflict. 387-404.
- Barnett, M. and Duvall, R. (2005) 'Power in Global Governance', in Barnett, M. and Duvall, R. (eds) *Power in Global Governance*, Cambridge: Cambridge University Press. pp. 1-33.
- Barton, J. H., Goldstein, J. L., Josling, T. E. and Steinberg, R. H. (2006) *The Evolution of the Trade Regime: Politics, Law, and Economics of the GATT and the WTO*, Princeton and Oxford: Princeton University Press.
- Baumont, M. (1952) 'Le Commerce depuis le Milieu du XIX Siècle. Livre I et II', in J. Lacour-Gayet (ed.), *Histoire du Commerce, Tome V*, Paris: Editions Spid.
- Bhagwati, J. (2002) *Free Trade Today*, Princeton, NJ. Princeton: Princeton University Press.
- Bhandari, J. S. and Sykes, A. O. (1998) *Economic Dimensions in International Law: Comparative and Empirical Perspectives*, Cambridge: Cambridge University Press.
- Bown, C. P. (2004a) 'Trade policy under the GATT/WTO: empirical evidence of the equal treatment rule', *Canadian Journal of Economics* 37, 3: 678-720.
- (2004b) 'Trade disputes and the implementation of protection under GATT: an empirical assessment', *Journal of International Economics* 62, 2: 263-294.
- (2004c) 'On the economic success of GATT/WTO dispute settlement', *The Review of Economics and Statistics* 86, 3: 811-823.
- Bown, C. P. and Crowley, M. (2006) 'Policy Externalities: How U.S. Antidumping Affects Japanese Exports to the EU', *European Journal of Political Economy* 22, 3: 696-714.
- (2007) 'Trade Deflection and Trade Depression', *Journal of International Economics*, forthcoming.
- Brainard, L. (1994) 'Last One Out Wins: Trade Policy in an International Exit Game', *International Economic Review* 35: 151-72.
- Brainard, L. S. and Verdier, T. (1994) 'Lobbying and Adjustment in Declining Industries', *European Economic Review* 38, 3-4: 586.
- Broda, C., Limao, N. and Weinstein, D. (2006) 'Optimal tariffs: the evidence', *NBER Working Paper* No 12033, Washington DC: National Bureau of Economic Research.
- Brooks, S. G. (1997) 'Dueling Realisms' *International Organization* 51, 3: 445-477.
- Bull, H. (1977) *The Anarchical Society*. London, UK: Macmillan.
- Bull, H. and Watson, A. (eds) (1984) *The Expansion of International Society*, Oxford, UK: Oxford University Press.
- Buzan, B. (2004) *From International to World Society? English School Theory and the Social Structure of Globalisation*, Cambridge: Cambridge University Press.
- Carmichael, C. (1987) 'The Control of Export Credit Subsidies and its Welfare Consequences', *Journal of International Economics* 23: 1-19.
- Carr, E. H. (1939) *The Twenty Years' Crisis, 1919-1939*, New York, NY: Harper and Row.

- Cass, D. Z. (2005) *The Constitutionalization of the WTO*, Oxford, UK: Oxford University Press.
- Chang, W. and Winters, A. L. (2001) 'How Regional Blocs Affect Excluded Countries: The Price Effects of MERCOSUR', *American Economic Review* 92, 4: 889-904.
- Charnovitz, S. (2004) 'The WTO and Cosmopolitics', *Journal of International Economic Law* 7, 3: 675-682.
- Chase-Dunn, C. (1998) *Global Formation: Structures of the World-Economy*, 2<sup>nd</sup> ed. Lanham, MD: Rowman and Littlefield.
- Checkel, J. T. (1998) 'The Constructivist Turn in International Relations Theory', *World Politics* 50, 2: 324-348.
- Clausewitz, C. von (1993) *On War*, Howard, M.E. and Paret, P. (eds). Princeton: Princeton University Press.
- Committee on Industry and Trade (1925) *Survey of Overseas Markets* (Balfour Report), London.
- Conybeare, J. A. C. (1984) Public Goods, Prisoners' Dilemma and the International Political Economy, *International Studies Quarterly* 28, 1: 5-22.
- Corden, M. (1997) *Trade Policy and Economic Welfare*, Oxford: Oxford University Press.
- Dam, K. W. (1970) *The GATT: Law and International Economic Organization*, Chicago: The University of Chicago Press.
- Dixit, A. (1987) 'Strategic aspects of trade policy', in T.F. Bewley (ed) *Advances in economic theory: fifth world congress*, New York: Cambridge University Press.
- Dobson, J (1976) *Two Centuries of Tariffs. The Background and Emergence of the United States Tariff Commission*, Washington, DC: US International Trade Commission.
- Downs, G. W. and Rocke, D. M. (1995) *Optimal Imperfection? Domestic Uncertainty and Institutions in International Relations*, Princeton: Princeton University Press.
- Drake, W. J and Nicolaïdis, K. (1992) 'Ideas, Interests and Institutionalization: 'Trade in Services' and the Uruguay Round' in Haas, P.M. (ed) *Knowledge, Power, and International Policy Coordination*, Columbia: University of South Carolina Press pp. 37-100.
- Dunoff, J. L. and Trachtman, J. P. (1999) 'Economic Analysis of International Law', *Yale Journal of International Law* 24, 1: 1-59.
- Dupont, C., Beverelli, C. and Pézard, S. (2006) 'Learning in Multilateral Trade Negotiations: Some Results from Simulation from Developing Countries', in Odell, J.S (ed) *Negotiating Trade: Developing Countries in the WTO and NAFTA*, Cambridge: Cambridge University Press. pp. 145-174.
- Eaton, J. and Kortum, S. (2002) 'Technology, Geography and Trade', *Econometrica* 70, 5: 1741-1780.
- Eschenbach, F. and Hoekman, B. (2006) 'Services Policies in Transition Economies: on the EU and WTO as commitment mechanisms', *World Trade Review* 5, 3: 415-443.
- Ethier, W. J. (2001) 'Punishments and Dispute Settlement in Trade Agreements', *PIER Working Paper* 01-21.
- (2001a) 'Theoretical problems in negotiating trade liberalization', *European Journal of Political Economy* 17: 209-232.
- (2004) 'Political externalities, Non-discrimination, and a Multilateral World', *Review of International Economics* 12, 3: 303-320.
- (2006) 'The theory of trade policy and trade agreements: a critique', *PIER Working Paper* No 06-013, Philadelphia: Penn Institute for Economic Research.
- Evans, P. B., Jacobson, H. K. and Putnam, R. D. (1993) *Double-Edged Diplomacy: International Bargaining and Domestic Politics*, Berkeley, Los Angeles, London: University of California Press.

Evans, T. and Wilson, P. (1992) 'Regime Theory and the English School of International Relations: A Comparison', *Millenium: Journal of International Studies* 21, 3: 330.

Falvey, R., Greenway, D. and Yu, Z. (2004) 'Intra-industry Trade Between Asymmetric Countries with Heterogeneous Firms', *Leverhulme Centre for Research on Globalization Economic Policy Working Paper* N. 2004/5.

Fearon, J. D. (1998) 'Bargaining, Enforcement, and International Cooperation', *International Organization* 52, 2: 269-305.

Finnemore, M. (1996) *National Interests in International Society*, Ithaca and London: Cornell University Press.

Finnemore, M. and Sikkink, K. (1998) 'International Norm Dynamics and Political Change', *International Organization* 52, 4: 887-918.

Frank, A. G. (1969) *Capitalism and Underdevelopment in Latin America: Historical Studies of Chile and Brazil*, New York, NY: Monthly Review Press.

Frieden, J. (2006) *Global Capitalism. It Fall and Rise in the Twentieth Century*, New York: W.W. Norton.

Gardner, R. N. (1980) *Sterling-Dollar Diplomacy in Current Perspective: The Origins and the Prospects of our International Economic Order*, New York: Columbia University Press.

Gawande K. and Bandyopadhyay, U. (2000) 'Is Protection for Sale? Evidence of the Grossman-Helpman Theory of Endogenous protection', *Review of Economics and Statistics* 82, 1: 139-152.

Gerhart, P. (2003) 'The Two Constitutional visions of the World Trade Organization', *Pennsylvania Journal of International Economic Law* 24, 1: 1-74.

Gilpin, R. (1987) *The Political Economy of International Relations*, Princeton: Princeton University Press.

Goldberg, P. K. and Maggi, G. (1999) 'Protection for Sale and Empirical Investigation', *American Economic Review* 84, 4: 1135-1155.

Goldstein, J (1993) 'Creating the GATT Rules: Politics, Institutions, and American Policy', in Ruggie, J.G. (ed) *Multilateralism Matters: The Theory and Praxis of an Institutional Form*, New York: Columbia University Press. pp. 201-232.

— (1996) 'International Law and Domestic Institutions: Reconciling North American Unfair Trade Laws', *International Organization* 50: 541-64.

— (1998) 'International Institutions and Domestic Politics: GATT, WTO, and the Liberalization of International Trade', in Krueger, A.O. (ed) *The WTO As An International Organization*, Chicago and London: The University of Chicago Press. pp. 133-152.

Goldstein, J. and Gowa, J. (2002) 'US National Power and the Postwar Trading Regime', *World Trade Review* 1, 2: 153-170.

Goldstein, J. and Keohane, R. O. (eds) (1993) *Ideas and Foreign Policy*, Ithaca: Cornell University Press.

Gourevitch, P. (2002) 'Domestic Politics and International Relations', in Carlsnaes, W., Simmons, B. and Risse, T. (eds) *Handbook of International Relations*, London, Thousand Oaks, New Delhi: Sage. pp. 309-328.

Gowa, J. (1989) 'Bipolarity, Multipolarity, and Free Trade', *American Political Science Review* 83, 4: 1245-1256.

Gowa, J. and Mansfield, E. D. (1993) 'Power Politics and International Trade', *American Political Science Review* 87, 2: 408-420.

— (2004) 'Alliances, Imperfect Markets, and Major-Power Trade'. *International Organization* 58, 4: 775-805.

Grieco, J. M. (1988) 'Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism', *International Organization* 42, 3: 485-507.

— (1990) *Cooperation among Nations: Europe, America and Non-Tariff Barriers to Trade*, Ithaca: Cornell University Press.

Grieco, J. M. and Ikenberry, G.J. (2003) *State Power and World Markets: The International Political Economy*, New York and London: W.W. Norton and Company.

Gros, D. (1987) 'A note on the optimal tariff, retaliation and the welfare loss from tariff wars in a framework with intra-industry trade', *Journal of International Economics* 23: 357-367.

Grossman, G. and Maggi, G. (1998) 'Free Trade versus Strategic Trade: A Peak into Pandora's Box', in Soto R., Ramachandran R. and Mino K. (eds) *Global Competition and Integration*, Dordrecht: Kluwer Academic.

Grossman, G. M. and Helpman, E. (1994) 'Protection for Sale', *American Economic Review* 84, September: 833-50.

— (1995a) 'Trade War and Trade Talks', *Journal of Political Economy* 103: 675-708.

— (1995b) 'The Politics of Free Trade Agreements', *American Economic Review* 85:667-90.

— (2001) *Special Interest Politics*, Cambridge, MA: MIT Press.

Gruber, L. (2000) *Ruling the World: Power Politics and the Rise of Supranational Institutions*, Princeton: Princeton University Press.

Gruenspecht, H. K. (1988) 'Dumping and Dynamic Competition', *Journal of International Economics* 25: 225-48.

Guzzini, G. (2002) 'A Reconstruction of Constructivism in International Relations', *European Journal of International Relations* 6, 2: 147-182.

Haas, E.B. (1990) *When Knowledge is Power: Three Models of Change in International Organizations*, Berkeley, Los Angeles, London: University of California Press.

Haas, P. M. (1992) 'Introduction: Epistemic Communities and International Policy Coordination', in P. M. Haas (ed) *Knowledge, Power, and International Policy Coordination*, Columbia: University of South Carolina Press. pp. 3-35.

Haggard, S. and Simmons, B.A. (1987) 'Theories of International Regimes', *International Organization* 41, 3: 491-517.

Harms, P., Mattoo, A. and Schuknecht, L. (2003) 'Explaining liberalization commitments in financial services trade', *World Bank Policy Research Paper* 2999.

Hasenclever, H., Mayer P. and Rittberger V. (1997) *Theories of International Regimes*, Cambridge: University Press.

— (2000) 'Integrating Theories of International Regimes', *Review of International Studies* 26, 1: 3-33.

Hillman, A. and Ursprung, H. W. (1988) 'Domestic Politics, Foreign Interests and International Trade Policy', *American Economic Review* 78, 4: 729-45.

Hirschman, A. O. (1980) *National Power and the Structure of Foreign Trade* (First published in 1945.) Expanded edition, Berkeley, CA: University of California Press. pp. v-52.

Holsti, K. J. (2004) *Taming the Sovereigns: Institutional Change in International Politics*, Cambridge: Cambridge University Press.

Horowitz, S. (2004) 'Reversing Globalization: Trade policy consequences of World War I', *European Journal of International Relations* 10, 1: 33-59.

Howse, R. and Nicolaidis, K. (2001). 'Legitimacy and Global Governance: Why Constitutionalizing the WTO is a Step too Far', in Porter, R. B. et al. (eds), *Efficiency, Equity, Legitimacy: The Multilateral Trading System at the Millennium*, Washington, D.C.: Brookings Institution Press.

Hudec, R. E. (1993) 'Circumventing Democracy: The Political Morality of Trade Negotiations', *N.Y.U. Journal of International Law & Politics* 25: 311-322.

Hull, C. (1948) *The Memoirs of Cordell Hull*, London: Hodder and Stoughton.

Ikenberry, G. J. (2001) *After Victory: Institutions, Strategic Restraint, and the Rebuilding of Order After Major Wars*, Princeton and Oxford: Princeton University Press.

Ikenberry, G. J., Lake, D. A., Mastanduno, M. (1989) 'The State and American Foreign Economic Policy', *International Organization* 42, 1: 1-14.

Ikenberry, J. G. and Kupchan, C. A. (1990) 'Socialization and Hegemonic Power', *International Organization* 44, 3: 283-315.

Irwin, D. A. (1993) 'Multilateral and Bilateral Trade Policies in the World Trading System: An Historical Perspective', in de Melo, J. and Panagariya, A. (eds) *New Dimensions in Regional Integration*, New York: Cambridge University Press. pp. 90-119.

— (1996) *Against the Tide: Intellectual History of Free Trade*, Princeton, NY: Princeton University Press.

— (1998) The Smoot-Hawley Tariff: A Quantitative Assessment, *The Review of Economics and Statistics*, Vol. LXXX.

Jackson, J.H. (1969) *World Trade and the Law of GATT*, New York: Bobbs-Merrill.

Jawara, F. and Kwa, A. (2004). *Behind the Scenes at the WTO: The Real World of International Trade Negotiations: Lessons of Cancun*, 2<sup>nd</sup> edition, London and New York : Zed Books (distributed by Palgrave, New York ).

Johnson, H. G. (1953-1954) 'Optimum tariffs and retaliation', *The Review of Economic Studies* 21, 2: 142-153.

Kapstein, E. (2003) 'Two Dismal Sciences Are Better Than One Economics and the Study of National Security, A Review Essay', *International Security* 27, 3: 158-187.

Keohane, R. O. (1984) *After Hegemony: Cooperation and Discord in the World Political Economy*, Princeton: Princeton University Press.

— (1993) 'Institutional Theory and the Realist Challenge After the Cold War', in Baldwin, D. A. (ed) *Neorealism and Neoliberalism: The Contemporary Debate*, New York: Columbia University Press pp.269-300.

— (2002) *Power and Governance in a Partially Globalized World*, London and New York: Routledge.

— (2005) *After Hegemony: Cooperation and Discord in the World Political Economy* (with a new preface by the author), Princeton and Oxford: Princeton University Press.

Kindleberger, C. P (1989) 'Commercial Policy between the Wars', in Mathias, P. and Pollard, S. (eds), *The Cambridge Economic History of Europe*, Volume VIII, The Industrial Economies: The Development of Economic and Social Policies, New York: Cambridge University Press. pp. 161-196.

— (1973) *The World in Depression, 1929-1939*, Berkely: University of California Press.

— (1975) 'The Rise of Free Trade in Western Europe, 1820-1875', in *The Journal of Economic History*, Volume XXXV.

Krasner, S. D. (1976) 'State Power and the Structure of International Trade', *World Politics* 28, 2: 317-347.

- (1983) 'Structural Causes and Regime Consequences: Regimes as Intervening Variables', in Krasner, S. D. (ed) *International Regimes*, Ithaca and London: Cornell University Press.
  - (1991) 'Global Communications and National Power: Life on the Pareto Frontier', *World Politics* 43: 336-366.
  - (1999) *Sovereignty: Organized Hypocrisy*, Princeton: Princeton University Press.
- Kratochwil, F. V. (1989) *Rules, Norms, and Decisions: On the Conditions of Practical and Legal Reasoning in International Relations and Domestic Affairs*, Cambridge: Cambridge University Press.
- Kratochwil, F. V. and Ruggie, J.G. (1986) 'International Organization: A State of the Art on an Art of the State', *International Organization* 40, 4: 753-775.
- Krishna, P. and Mitra, D. (1999) 'Reciprocated Unilateralism: A political Economy Perspective', mimeo, Brown University.
- (2005) 'Reciprocated Unilateralism in Trade Policy' *Journal of International Economics* 65, 2: 461-487.
- Kydland, F. E. and Prescott, E. C. (1977) 'Rules Rather Than Discretion: The Inconsistency of Optimal Plans', *Journal of Political Economy* 85, 3: 473-91.
- Lake, D. (1993) 'Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch with Potential?', *International Studies Quarterly* 37: 459-489.
- Lal, D. (2006) *Reviving the Invisible Hand*, Princeton: University Press.
- Lamy, P. (2001) 'Harnessing globalisation: do we need cosmopolitics?', Lecture given at the London School of Economics on February 1, 2001. Available [http://trade-info.cec.eu.int/doclib/docs/2004/october/tradoc\\_119391.pdf](http://trade-info.cec.eu.int/doclib/docs/2004/october/tradoc_119391.pdf). Accessed 06/02/07.
- Lang, A. T. F. (2006) 'Reconstructing Embedded Liberalism: John Gerard Ruggie and Constructivist Approaches to the Study of the International Trade Regime', *Journal of International Economic Law* 9, 1: 81-116.
- Lapan, H. E (1988) 'The Optimal Tariff, Production Lags and Time Consistency', *American Economic Review* 78, 3: 395-401.
- Lavergne, R. P. (1983) *The Political Economy of US Tariffs: An Empirical Analysis*, Toronto: Academic Press.
- League of Nations (1927) Economic and Financial Section, International Economic Conference, Documentation, 'Tariff Level Indices', Geneva.
- (1942) Economic and Financial Transit Department, 'Commercial Policy in the Interwar Period. International Proposals and National Policies', Geneva.
  - (1945) Report of the Economic and Financial Committees, 'Commercial Policy in the Post-War World'. Official No.: C.31.M.31.1945.II.A (April 1945).
- Lewis, A. (1981) The Rate of Growth of World Trade, 1830-1973, in Grossmann and Lundberg (ed) *The World Economic Order. Past and Prospects*.
- Liepmann, H. (1938) *Tariff Levels and the Economic Unity of Europe*, London: Allen, G. & Unwin.
- Limão, N. (2005) 'Preferential agreements as stumbling blocks for multilateral trade liberalization – evidence for the U.S.', *CEPR Discussion Paper* No 4884, London: Centre for Economic Policy Research.
- (2006) 'Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade Liberalization: Evidence for the United State', *American Economic Review* 96, 3: 896-914.
- Mac Callum, P. (2004) 'Protection for Sale and Trade Liberalization: an Empirical Investigation', *Review of International Economics* 12, 1: 81-94.

- Maddison, A. (1962) 'Growth and Fluctuation in the World Economy, 1870-1960', *Banca Nazionale del Lavoro Quarterly Review*, No. 61, June.
- (2001) *The World Economy: A Millennial Perspective*, Paris: OECD.
- Magee, S. P., Brock, W. A. and Young, L. (1989) 'Black Hole Tariffs and Endogenous Policy Theory: Political Economy in General Equilibrium', Cambridge: Cambridge University Press.
- Magelby, D. B. and Nelson, C. J. (1990) 'The Money Case: Congressional Campaign Finance Reform', Washington, DC: Brookings Institution.
- Maggi, G. and Rodriguez-Clare, A. (1998) 'The Value of Trade Agreements in the Presence of Political Pressures', *Journal of Political Economy* 106, 3: 574-601.
- (2007) 'A political Economy Theory of Trade Agreements', *American Economic Review*, forthcoming.
- Mansfield, E. D. and Bronson, R. (1997) 'Alliances, Preferential Trading Arrangements, and International Trade', *American Political Science Review* 91, 1: 94-107.
- Mansfield, E. D. and Reinhardt, E. (2003) 'Multilateral Determinants of Regionalism: The Effects of GATT/WTO on the Formation of Preferential Trading Arrangements', *International Organization* 57, 3: 829-862.
- Mansfield, E. D., Milner, H. V. and Rosendorff, B. P. (2002). 'Why Democracies Cooperate More: Electoral Control and International Trade Agreements', *International Organization* 56, 3: 477-513.
- Martin, L. L. (1993) 'The Rational State Choice of Multilateralism', in Ruggie, J.G. (ed.) *Multilateralism Matters: The Theory and Praxis of an Institutional Form*, New York: Columbia University Press. pp. 91-121.
- Martin, L. L. and Simmons, B. A. (1998) 'Theories and Empirical Studies of International Institutions', *International Organization* 52, 4: 729-775.
- Martin, P., Mayer, T. and Thoenig, M. (2005) 'Make Trade not War?', *CEPR, Discussion Paper Series N.* 5218.
- Maskin, E. and Newberry, D. (1990) 'Disadvantageous Oil Tariffs and Dynamic Consistency', *American Economic Review* 80: 143-56.
- Matsuyama, K. (1990) 'Perfect Equilibria in a Trade Liberalization Game', *American Economic Review* 80:480-492.
- Mavroidis, P. (2007) *Trade in Goods*, Oxford, UK: Oxford University Press (forthcoming).
- Mayer, W. (1984) 'Endogenous Tariff Formation', *American Economic Review* 74: 970-85.
- (1994) 'Optimal Pursuit of Safeguard Actions Over Time', in Deardoff, A. and Stern, R. (eds) *Analytical and Negotiating Issues in the Global Trading System*, Ann Arbor: University of Michigan Press.
- McGinnis, J. O. and Movsesian, M. L. (2000) 'The World Trade Constitution', *Harvard Law Review* 114: 511-605.
- McLaren, J. (1997) 'Size, Sunk Costs and Judge Bowker's Objection to Free Trade', *American Economic Review* 87: 400-20.
- (2002) 'A Theory of Insidious Regionalism', *Quarterly Journal of Economics* 117, 2: 571-608.
- Mearsheimer, J. J. (1995) 'The False Promise of International Institutions', *International Security* 19, 3: 5-49.
- Melitz, M. J. (2003) 'The Impact of Trade on Intra-Industry Reallocation and Aggregate Industry Productivity', *Econometrica* 71, 6: 1695-1725.
- Mill, J. S. (1844) *Essays on some unsettled questions of political economy*, London: Parker.



- Miller, J. N. (2000) 'Origins of the GATT: British resistance to American multilateralism', *Cambridge University Jerome Levy Economics Institute at Bard College, Working Paper* no. 318.
- Milner, H. V. (1988) *Resisting Protectionism: Global Industries and the Politics of International Trade*, Princeton, NJ: Princeton University Press.
- (1998) *Interests, Institutions and Information: Domestic Politics and International Relations*, Princeton: Princeton University Press.
- (2002) 'International Trade', in Carlsnaes, W., Simmons, B. and Risse, T. (eds) *Handbook of International Relations*, London, Thousand Oaks, New Delhi: Sage. pp. 448-461.
- Milner, H. V. and Rosendorff, B. P. (1997) 'Democratic Politics and International Trade Negotiations: Elections and Divided Government as Constraints on Trade Liberalization', *Journal of Conflict Resolution* 41, 1: 117-46.
- Mitra, D. (1999) 'Endogenous Lobby Formation and Endogenous Protection: A Long-Run Model of Trade Policy Determination', *American Economic Review* 89: 1116-34.
- Mitra, D., Thomakos, D. D. and Ulubasoglu, M. A. (2002) 'Protection for Sale in a Developing Country: Democracy versus Dictatorship', *Review of Economics and Statistics* 84, 3: 497-508.
- Moravcsik, A. (1997) 'Taking Preferences Seriously: A Liberal Theory of International Politics', *International Organization* 51, 4: 513-553.
- (1998) *The Choice for Europe: Social Purpose & State Power from Messina to Maastricht*, London: Cornell University Press.
- Morgenthau, H. (1948) *Politics Among Nations: The Struggle for Power and Peace*, New York, NY: Knopf.
- Morrow, J. D. (1994) 'Modeling the Forms of International Cooperation: Distribution Versus Information', *International Organization* 48, 3: 387-423.
- (1997) 'When Do 'Relative Gains' Impede Trade?', *Journal of Conflict Resolution* 41, 1: 12-37.
- Nolde, B. (1932) *La Clause De La Nation La Plus Favorisée et les Tarifs Préférentiels*, Académie de Droit International, Recueil de Cours, Tome 39.
- Norbohm, J. O. (1962) *International Trade Statistics 1900-1960*, (unpublished document of UN Statistical Office), New York.
- Odell, J. (1990) 'Understanding International Trade Policies: An Emerging Synthesis', *World Politics* 43 (October): 139-167.
- Odell, J. and Sell, S. (2006) 'Reframing the Issue: The Coalition on Intellectual Property and Public Health in the WTO, 2001' in Odell, J. (ed.) *Negotiating Trade: Developing Countries in the WTO and NAFTA*. New York, NY: Cambridge University Press.
- O'Rourke, K. (2007) *Power and Plenty: Trade, War, and the World Economy in the Second Millennium*. Forthcoming Fall 2007, Princeton University Press.
- O'Rourke, K. and Williamson, J. (1999) *Globalization and History. The Evolution of a Nineteenth Century Atlantic Economy*, Cambridge MA: MIT Press.
- Ostrom, E. (2003) 'How types of goods and property rights jointly affect collective action', *Journal of Theoretical Politics* 15, 3: 239-270.
- Pauwelyn, J. (2006) 'Optimal Protection of International Law: Navigating between "European Absolutism" and "American Voluntarism"', mimeo. Available at [http://www.law.duke.edu/fac/pauwelyn/pdf/optional\\_protection.pdf](http://www.law.duke.edu/fac/pauwelyn/pdf/optional_protection.pdf). Accessed 06/02/2007.
- Penrose, E. F. (1953) *Economic Planning for the Peace*. Princeton, NJ: Princeton University Press.

Petersmann, E.-U. (1986) 'Trade Policy as a Constitutional Problem. On the 'Domestic Policy Functions' of International Trade Rules', *Aussenwirtschaft* 41: 405-439.

- (1995) 'The Transformation of the World Trading System Through the 1994 Agreement Establishing the World Trade Organization', *European Journal of International Law* 6: 1-61.
- (1998) 'From the Hobbesian International Law of Coexistence to Modern Integration Law: The WTO Dispute Settlement System', *Journal of International Economic Law* 1: 175-198.
- (2005) 'Addressing Institutional Challenges to the WTO in the New Millennium: A Longer-Term Perspective', *Journal of International Economic Law* 8, 3: 647-665.
- (2006) 'Multilevel Trade Governance in the WTO Requires Multilevel Constitutionalism', in: Joerges, C. and Petersmann, E.-U.: *Constitutionalism, Multilevel Trade Governance and Social Regulation*, Hart Publishing, Portland, OR.

Polachek, S. W. (1992) 'Conflict and Trade: An Economic Approach to Political Interactions', in Isard, W. and Anderton, C.H. (eds) *Economics of Arms Reduction and the Peace Process*, Amsterdam: North-Holland.

- (1997) 'Why Democracies Cooperate More and Fight Less: The Relationship Between International Trade and Cooperation', *Review of International Economics* 5, 1: 295-309.

Pomfret, R. (1997) *The Economics of Regional Trading Arrangements*, Oxford: Clarendon Press.

Posner, R. A. (1988) *Economic Analysis of the Law*. Boston, MA: Little, Brown and Co.

Powell, R. (1991) 'Absolute Gains and Relative Gains in International Relations Theory', *American Political Science Review* 85, 4: 1303-1320.

Putnam, R. D. (1988) 'Diplomacy and Domestic Politics: The Logic of Two-Level Games', *International Organization* 42, 3: 427-60.

Rappard, W. (1938) *Post-War Efforts For Freer Trade*, Geneva Studies, Volume IX, No.2, Geneva.

Ravenhill, J. (ed) (2005) *Global Political Economy*, Oxford, UK: Oxford University Press.

Regan, D. (2006) 'What Are Trade Agreements For? – Two Conflicting Stories Told by Economists, With a Lesson for Lawyers', *Journal of International Economic Law* 9, 4: 951-988.

Reus-Smit, C. (1997) 'The Constitutional Structure of International Society and the Nature of Fundamental Institutions', *International Organization* 51, 4: 555-589.

Riedel, J. C. (1977) 'Tariff Concessions in the Kennedy Round and the Structure of Protection in West Germany: An econometric Assessment', *Journal of International Economics* 7: 133-43.

Rittberger, V. (1993) 'Research on International Regimes in Germany: The Adaptive Internalization of an American Concept', in Rittberger, V. (ed) *Regime Theory and International Relations*, Oxford: Clarendon Press. pp. 3-22.

Rodrik, D. (1995) 'Political Economy of Trade Policy', in Grossman, G. and Rogoff, K. (eds) *Handbook of International Economics*. Amsterdam: New Holland. pp. 457-1494.

Ruggie, J. G. (1982) 'International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order', *International Organization*, 36, 2: 379-415.

- (1983) 'International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order', in Krasner, S.D. (ed) *International Regimes*, Ithaca and London: Cornell University Press. pp. 195-231.

- (1998) *Constructing the World Polity: Essays on International Institutionalization*, London and New York: Routledge.

Ruggie, J. G. (ed) (1993) *Multilateralism Matters: The Theory and Praxis of an Institutional Form*, New York: Columbia University Press.

- Sandler, T. (1992) *Collective Action. Theory and Applications*, Ann Arbor: University of Michigan Press.
- Schermers, H. and Blokker, N. (1995) *International Institutional Law: Unity Within Diversity*. 3rd rev. edition, Cambridge, MA: Kluwer Law International.
- Shaffer, G. (2005) 'Power, Governance, and the WTO: A Comparative Institutional Approach', in Barnett, M. and Duvall, R. (eds) *Power in Global Governance*, Cambridge: Cambridge University Press. pp. 130-160.
- Shirono, K. (2003) 'Are WTO tariff negotiations reciprocal ? an analysis of tariff liberalization', mimeo, Columbia University.
- Simmons, B. A. and Martin, L. L. (2002) 'International Organizations and Institutions', in Carlsnaes, W., Simmons, B. and Risse, T. (eds) *Handbook of International Relations*, London, Thousand Oaks, New Delhi: Sage. pp. 192-211.
- Snidal, D. (1985) 'The Limits of Hegemonic Stability Theory', *International Organization* 39, 4: 579-614.
- (1991) 'Relative Gains and the Pattern of International Cooperation', *American Political Science Review* 85, 3: 701-726.
- (1997) 'International Political Economy Approaches to International Institutions', in Bhandari, J.S. and Sykes, A.O. (eds) *Economic Dimensions in International Law: Comparative and Empirical Perspectives*, Cambridge: Cambridge University Press. pp. 477-512.
- (2002) 'Rational Choice and International Relations', in Carlsnaes, W., Simmons, B. and Risse, T. (eds) *Handbook of International Relations*, London, Thousand Oaks, New Delhi: Sage. pp. 73-94.
- Snyder, J. M. Jr (1990) 'Campaign Contributions as Investments: The US House of Representatives, 1980-86', *Journal of Political Economy* 98: 1195-1227.
- Staiger, R. W. (2004) 'Report on the international trade regime for the international task force on global public goods', available at <http://www.gpgtaskforce.org/uploads/files/200.pdf>. Accessed 22/02/2007.
- (2006) 'Review of Behind the Scenes at the WTO: the Real World of International Trade Negotiations: Lessons of Cancun', *Journal of Economic Literature* XLIV: 428-442.
- Staiger, R. W. and Tabellini, G. (1987) 'Discretionary Trade Policy and Excessive Protection' *American Economic Review* 77, 5: 823-837.
- (1989) 'Rules and Discretion in Trade Policy', *European Economic Review* 33: 1265-77.
- (1999) 'Do GATT Rules Help Governments Make Domestic Commitments?', *Economics and Politics* 11, 2: 109-144.
- Stein, A. (1983) 'Coordination and Collaboration Regimes in an Anarchic World', in Krasner, S.D. (ed) *International Regimes*, Ithaca and London: Cornell University Press. pp. 115-140.
- Steinberg, R. H. (2002) 'Consensus-Based Bargaining and Outcomes in the GATT/WTO', *International Organization* 56, 2: 339-374.
- Strange, S. (1982) 'Cave! Hic Dragones: A Critique of Regime Analysis', *International Organization* 36, 2: 479-496.
- Sykes, A. O. (1999) 'International Trade', in Bouckaert, B. and de Geest, G. (eds) *Encyclopedia of Law and Economics*, Ghent: Edward Elgar, University of Ghent, Chapter 5910, pp. 1114-32.
- Tarullo, D. (2002) 'Book Review: The EU and the WTO: Legal and Constitutional Issues', *Journal of International Economic Law* 5, 4: 941-943.
- Thorn, G. (1970) 'Développement économique et obstacles au commerce international au XIX siècle', in *Revue de l'Institut de Sociologie* N° 3: 497-517, Université de Bruxelles.

Tornell, A. (1991) 'Time Inconsistency of Protectionists Programs', *Quarterly Journal of Economics*, 106, August: 963-74.

Torrens, R. (1844) *The budget: on commercial policy and colonial policy*, London: Smith, Elder.

Tosini, S. C. and Tower, E. (1987) 'The Textile Bill of 1985: The Determinants of Congressional Voting Patterns', *Public Choice* 54, 1: 19-25.

Trefler, D. (1993) 'Trade Liberalization and The Theory of Endogenous Protection: An Econometric Study of US Import Policy', *Journal of Political Economy* 101: 138-60.

Tumlir, J. (1985) 'Conception of the International Economic and Legal Order', *World Economy* 8: 85-87.

United Nations (1970) *Statistical Yearbook 1969*, New York: United Nations.

Wallerstein, I. (1974) *The Modern World-System: Capitalist Agriculture and the Origins of the European World-Economy in the Sixteenth Century*, New York, NY: Academic Press.

Waltz, K. (1954) *Man, State, and War: A Theoretical Analysis*, New York, NY: Columbia University Press.

Wendt, A. (1999) *Social Theory of International Politics*, Cambridge: Cambridge University Press.

Whalley, J. (1985) *Trade liberalization among major trading areas*, Cambridge: MIT Press.

Williams, J. (1947) 'Economic lessons of two world wars', *Foreign Affairs*, October.

Wolfe, R. (2006) 'New Groups in the WTO Agricultural Trade Negotiations: Power, Learning and Institutional Design', *CATPRN Commissioned Paper CP 2006-2*.

Woodruff, W. (1971) 'The emergence of an international economy 1700-1914', in Cipolla (ed) *The Fontana Economic History of Europe* 4: 662.

Young, O. R. (1999) *Governance in World Affairs*, Ithaca and London: Cornell University Press.