

## E. Prospects for multilateral trade cooperation

This section explores the relevance of current trade rules – as well as the need for new approaches to trade cooperation – in light of the forces that are currently re-shaping international trade. It suggests that the multilateral trading system will need to adjust to developments in trade and in the trading environment – as it has done repeatedly in the past – and reviews proposals for updating the WTO’s agenda and governance. The section starts with a short overview of key trade developments within the broader socio-economic context – especially the rise of global supply chains, the general shift of trade power away from the West and towards Asia and other emerging economies, as well as the changing nature, composition and direction of trade. It then highlights some of the main challenges facing the WTO and how they could be addressed.

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## Some key facts and findings

- Some of the main trends which will affect world trade in the coming decades are the emergence of international supply chains, the rise of new forms of regionalism, the growth of trade in services, higher and more volatile commodity prices, the rise of emerging economies, and evolving perceptions about the link between trade, jobs and the environment.
- These trends will raise a number of challenges for the WTO. A considerable amount of trade opening is taking place outside of the WTO. Interdependence between trade in goods and trade in services is increasing. Frictions in natural resource markets expose some regulatory gaps. The emergence of new players affects global trade governance in ways that need to be better understood. Coherence between WTO rules and non-trade regulations in other multilateral fora needs to be maintained.
- Addressing these challenges will involve reviewing and possibly expanding the WTO agenda. Traditional market access issues will not disappear but new issues are emerging. Internal governance matters as well as the role of the WTO in global governance may need to be addressed. An important issue will be how to “multilateralize” the gains made in preferential trade agreements and to secure regulatory convergence.

## 1. Main trends in trade

This sub-section provides a short summary of some of the main findings of Sections B, C and D that may have implications for the WTO.

### (a) Trends in the nature of trade

A trend emphasized throughout this report and that has a major impact on other developments is the emergence of global supply chains. Countries and producers increasingly specialize in certain stages of production depending on their particular comparative advantage. Section B stresses the importance and magnitude of this development for international trade. In particular, its impact on trade statistics is analysed in detail. In Section C, several important factors influencing these supply chains are discussed. Transport and energy costs, for instance, are reasons why these chains remain more regional than global.

A related trend is the new form of regionalism that is sometimes referred to as “deep” integration (Baldwin, 2012a). The need for firms to organize their supply chains across different countries has led to a demand for regional agreements that cover more than preferential tariffs. The harmonization of standards and rules on investment, intellectual property and services has become a standard part of new trade agreements (WTO, 2011a).

Section B also discusses the differences among firms involved in trade. The picture that arises from the trade literature and the data is that even if many firms are indirectly involved in trade-related activities, only relatively few are exporting or importing and these firms tend to be larger and more productive than others. Such firms also have a role in technology advancement and the diffusion of know-how through supply chains.

### (b) Trends in the composition of trade

Section B shows that trade in services has grown faster than trade in goods over the last two decades, while Section C describes how advances in information and communication technology have enabled a rapid expansion of services trade. This trend might in the future be spurred by rising energy costs. Moreover, the share of services in both manufacturing firms' inputs and outputs has increased and the “frontier” between goods and services is increasingly blurred. Digitalization and 3D printing are examples of the increasing grey zone between goods and services. Whether they are classified as one or the other is significant as different regulatory regimes might apply.

With regard to natural resources, Section B shows that their price has increased and that the price of food products has become more volatile. Section C explores

in more detail the reasons behind the trends in the price of energy. Section D discusses how higher and more volatile agricultural commodity prices raise concerns regarding food security in developing countries.

### (c) Trends in the geography of trade

Another major trend in international trade is the rise of a number of emerging economies and the associated increase in their shares in world trade. Especially China but also India and Brazil have transformed the balance of power in the multilateral trading system. Section B describes the growth in the share of world trade of China and other emerging economies. Between 1980 and 2011, for example, China's share in world merchandise exports and imports increased tenfold, making the country the largest exporter of the world.

Section C finds that a comparable development has occurred in foreign direct investment. Inflows into developing countries and outflows from these countries now represent a major share of total foreign direct investment (FDI), and FDI between developing countries is rapidly expanding. Related to this development is the industrialization of developing countries and de-industrialization of developed countries which, once again, is closely interconnected with global supply chains. However, this growth is limited to only a few economies. It has caused greater differences among developing countries, with growing emerging economies and struggling least-developed countries (LDCs).

### (d) Trends in the broader socio-economic context

Section D looks at trends in the broader socio-economic context within which trade takes place. Distributional effects of trade play an important role here. The section examines the extent to which the recent sharp increase in the unemployment rates of developed countries may be linked to trade and what this could mean for attitudes towards trade. While there is no conclusive evidence that trade contributes significantly to changes in long-run unemployment or in income inequality, public concerns about current levels of unemployment and income distribution in a number of countries are likely to have a bearing on trade policy-making.

Another ongoing trend is the increasing importance of consumer concerns (regarding the environment or food safety, for example) which has led to a proliferation of public policy measures that affect trade (WTO, 2012b). Global supply chains might exacerbate the issue when large firms impose private standards throughout their respective supply chains. A further trend is the fierce competition for scarce natural

resources that leads to a more frequent use of export restrictions, as examined in the 2010 *World Trade Report* (WTO, 2010).

## 2. Challenges for the WTO

A number of developments identified in this report raise a transparency challenge for the multilateral trading system. First, as explained in Section B, the expansion of supply chains is difficult to quantify with the available trade statistics, which are collected in gross terms. Efforts are being made to generate statistics on trade in value-added terms but more information will be needed on various other aspects of supply chains. The key role of services, for example, is not adequately captured by existing statistics. Similarly, more and better information on FDI is needed to assess the effect of offshoring. Secondly, as discussed in Section D, non-tariff measures (NTMs) related to public policy, which have proliferated in recent years, are particularly opaque.<sup>1</sup> This opaqueness raises problems not only for businesses but also for the multilateral trading system. Existing WTO transparency mechanisms and efforts undertaken by other institutions shed some light in a number of areas but more remains to be done.

### (a) Internationalization of supply chains

One major development that has substantially transformed – and is likely to continue to transform – world trade and the world economy as a whole is the emergence and expansion of global supply chains. According to some economists, the significance of this internationalization of supply chains goes beyond increasing trade in parts and components; in some ways, it is the most important development in the world economy since the beginnings of globalization (Baldwin, 2012a).

The industrialization and spectacular growth of emerging economies, together with the fast expansion of services trade and of FDI, are inextricably related to what Baldwin calls the “second unbundling” of production. The focus here will be on how the rise of global supply chains has had an impact on the political economy of trade and countries’ motivations for cooperating on trade policies. There is both theory and evidence suggesting that participation in global supply chains tends to strengthen anti-protectionist forces. These forces have helped to drive some multilateral trade opening in the WTO, both in specific sectoral as well as in broader accession-related negotiations (with 32 governments joining the WTO since its creation in 1995). The main impact, however, has been on unilateral tariff reductions (mostly among developing countries) and the proliferation of preferential trade agreements (PTAs) and bilateral investment treaties (WTO, 2011a). A considerable amount of trade opening has thus taken place outside the WTO.

### (i) *Unilateral tariff reductions*

The internationalization of supply chains has opened up an alternative industrialization path for developing countries (Baldwin, 2011a). Before the emergence of supply chains – and the information and communication technology (ICT) revolution that underpinned it – industrialization involved building a strong industrial base often behind the protection of tariffs and other NTMs. The unbundling of global production made it possible for countries to industrialize by joining international supply chains. This process also changed the political economy of trade policy, creating in many developing countries a strong incentive to undertake unilateral tariff reductions.

Baldwin (2011a) identifies three mechanisms through which production unbundling can lead to unilateral tariff reductions. First, the offshoring of production is likely to alter lobbying over trade policy in the host country. The relocation of production transforms importers of the products concerned into exporters. As a result, lobbying in favour of import tariffs on these goods decreases and pressure to reduce upstream tariffs increases.<sup>2</sup> This effect, however, is more limited in cases where governments set up export processing zones to exploit the growing industrialization opportunities offered by supply chains.

Secondly, a fall in coordination and communication costs may also have an impact on lobbying. With high “frictional” trade costs, producers of final products may support infant industry protection of intermediate products if they believe that it could lower the price of domestically produced intermediate goods compared with imports. However, a fall in coordination and communication costs can break the coalition of interests behind high trade barriers, and lead downstream producers to lobby against tariffs on intermediate goods.

Thirdly, offshoring improves the competitiveness of developed countries’ products by reducing their costs, thus undermining import substitution strategies in developing countries. Developing country governments may either respond by lowering the tariffs on final goods, or, alternatively, by lowering upstream tariffs to improve the competitiveness of domestic final goods.

Empirical evidence seems to confirm that lobbying is indeed an important determinant of trade policy (Gawande et al., 2012). In particular, there is evidence suggesting that supply chains can explain why the recent financial crisis did not lead to significant protectionism despite the fact that many countries had “water” in their applied tariffs, meaning they could raise them without violating their “bound” WTO commitments (Gawande et al., 2011).

While unilateral tariff reductions have clearly been a positive step in the direction of more open trade, they

may also have complicated multilateral, reciprocity-based tariff reductions in the WTO. Baldwin (2010a) argues that developing countries have already significantly reduced their applied tariffs, giving developed country exporters less to fight for in multilateral negotiations. Developed country exporters also see less value in asking developing countries to commit to lower tariffs because they do not believe that developing country governments have strong incentives to raise them.<sup>3</sup> In Baldwin's view, because multilateral tariff reductions are driven by the exchange of market access, the fact that developing countries have less to offer has weakened the logic of further negotiations.<sup>4</sup>

Blanchard (2010) makes a related point, arguing that foreign investment may lead governments to unilaterally reduce tariffs, thereby lowering the incentive to exchange tariff reductions in the WTO. Existing theoretical work suggests that a government's optimal tariff decreases when its constituents hold an ownership stake in a foreign market, leaving it with less incentive to manipulate the terms of trade. Extending a terms-of-trade model of trade agreements to account for international ownership, Blanchard shows that by eroding large countries' motives to improve terms of trade by raising tariffs, international ownership can also reduce their incentive to sign trade agreements. Blanchard also suggests that calculations of reciprocity in tariff negotiations should consider patterns of international ownership as well as trade flows.

Unilateral tariff reductions, in as much as they were not bound in the WTO,<sup>5</sup> have tended to increase the level of "water" in developing countries' tariffs – i.e. the difference between the level at which tariffs are bound and the level at which they are applied – which has in turn complicated the Doha Development Agenda (DDA) non-agricultural market access negotiations. In the DDA's early days, discussion focused on the question of whether and how credit should be granted for autonomous trade opening (Mattoo and Olarreaga, 2001). Even when WTO members "agreed" to negotiate reductions of their bound, rather than applied, tariff rates, the underlying problem did not disappear but merely reappeared under a different guise. Members started arguing about the value of so-called "paper cuts", i.e. reductions of bound rates that do not imply equivalent reductions of the corresponding applied rate.

### *(ii) Reciprocal trade opening*

The changing dynamics of trade policy brought about by the internationalization of supply chains have not only resulted in unilateral tariff reductions but also in negotiated tariff reductions in the WTO (e.g. the Information Technology Agreement) and, even more significantly, in fast-proliferating PTAs (WTO, 2011a). While in many cases, particularly in Asia, these PTAs are aimed at "deep" integration and rule-making, they

typically also include a traditional tariff component. In other cases, such as PTAs in Africa, tariffs are central to the agreements.

Preferential tariffs raise several challenges for the multilateral trading system. One concern, extensively discussed in the economic literature, on the systemic effects of preferential tariff reductions relates to the linkages between discriminatory and non-discriminatory tariff reductions.<sup>6</sup> A number of different mechanisms have been identified through which PTAs either foster or hinder multilateral trade opening. While the evidence on the relative size of these effects is inconclusive, there is a shared sense among observers that the coherence between PTAs and the WTO needs to be improved (WTO, 2011a).

### *(iii) Deep integration at the regional/ bilateral level*

In order for international supply chains to operate smoothly, certain national policies need to be harmonized – or rendered mutually compatible – to facilitate business activities across borders.<sup>7</sup> This generates a demand for deep forms of integration.<sup>8</sup> Developed countries were the first to sign regional agreements aimed at providing rules to accommodate internationally fragmented production.

With the expansion of international production sharing, developing countries too began to enter into deep integration agreements, especially at the regional level.<sup>9</sup> Both North-South agreements (between developed and developing countries), such as the North American Free Trade Agreement or the Euro-Mediterranean agreements, and South-South agreements (between developing countries), mostly in Asia, include provisions that go beyond preferential tariff reductions. As suggested by the current Trans-Pacific Partnership negotiations and the Pacific Alliance initiative in Latin America, this trend is unlikely to change.

The fact that governments respond to the internationalization of supply chains by signing deep integration agreements at the regional level is broadly consistent with the limited amount of theory available on this topic (WTO, 2012b). According to Antràs and Staiger, deep rather than shallow integration agreements and more individualized rules are needed to address the policy problems associated with the internationalization of supply chains (Antràs and Staiger, 2012). Countries intensively involved in supply chain trade may find it increasingly difficult to rely on broad GATT/WTO principles alone to address their trade-related problems, and may turn to more narrowly focused PTAs to achieve the deep and customized bargains they need.

An important result of the terms-of-trade theory is that shallow integration, i.e. tariff commitments plus an

effective “market access preservation rule”, can achieve internationally efficient policies (Bagwell and Staiger, 1999; 2001). However, Antràs and Staiger (2012) find that this result does not hold in the presence of offshoring and, more generally, when international prices are determined through bargaining. If producers are locked into trade relationships with foreign firms – and prices are set via bargaining – there are incentives to manipulate the markets of both the intermediate and the final product to shift the bargaining surplus. Governments might also try to pursue redistributive goals via a trading partner’s policies. Deep integration agreements are needed to resist these pressures. However, this in turn means that negotiations must cover a wider array of internal/ domestic measures than are typically covered in “shallow” trade agreements.

Thus, the rise of offshoring raises both a direct and an indirect challenge for the WTO. It puts direct pressure on the WTO to evolve towards deeper integration and more individualized agreements. It also puts indirect pressure on the WTO to evolve in this direction, as member governments increasingly turn to PTAs to solve their trade-related problems. As a result, Baldwin (2012b) argues that the WTO runs the risk of becoming irrelevant.

The 2011 *World Trade Report* (WTO, 2011a) explored the effect of proliferating deep regional agreements on coherence in international trade governance. It suggested that new international trade rules are being negotiated and decided outside the WTO where power differences are greater and where the principles of non-discrimination and reciprocity are absent. It also argued that PTAs are here to stay. Governments will need to ensure that regional agreements and the multilateral trading system are complementary and that multilateral disciplines minimize any negative effects from PTAs.

While the available literature suggests that deep integration rules are often non-discriminatory – for instance, provisions in the services or competition policy areas are often extended to non-members<sup>10</sup> – certain provisions in regional agreements can contain discriminatory aspects that clash with the multilateral trading system. It has been shown that PTAs which make it more difficult to apply contingency measures to PTA partners may divert protectionist measures towards non-members (Prusa and Teh, 2010). Deep provisions can also have a number of adverse systemic effects. For example, the “lock-in” effects of regional regulatory harmonization can make it more difficult to multilateralize rules. PTAs may not include third-party most-favoured nation (MFN) clauses, thus effectively discriminating against other countries. Developed country exporters may view bilateral and regional rather than multilateral agreements as faster and easier routes for achieving their objectives, further weakening the principle of non-discrimination.<sup>11</sup>

With regard to services supply chains, some argue that their growth creates an additional need to re-examine and modernize current rules for services trade, as these rules were designed for a world where services were exported as final products from national firms, not a world where multiple firms supply stages of services production from multiple locations (Stephenson, 2012). This argument is discussed in more detail in Section E.2(b).

Recent research (see Box E.1) on how differences in firms have an impact on trade policies reveals a related concern.<sup>12</sup> Section B pointed out that a few multinational firms are responsible for a major share of world trade. On the one hand, these firms should support regulatory harmonization across different PTAs in order to lower trade costs. On the other hand, they might also resist harmonization – and encourage certain non-tariff measures – in order to prevent new competitors from entering markets. This may partly explain the persistence of regulatory divergence, and suggests that the political economy of regulatory convergence may be more complex than is sometimes suggested.

#### (iv) *Bilateral investment agreements*

As argued by Baldwin (2012b), the internationalization of supply chains has created a “trade-investment-service nexus” which requires new, more complex rules, including on investment. Rules regulating FDI are mainly embodied in bilateral investment treaties (BITs), which have proliferated since the mid-1980s, and more recently in preferential trade agreements (WTO, 2011a). There is significant variation among investment treaties. For example, many include only post-establishment obligations and thus result in limited trade opening. Another question is whether bilateral and regional approaches are optimal for governing investment flows.<sup>13</sup> While there is some potential for third-party investment discrimination through BITs and regional agreements (WTO, 2011a), opinions regarding the benefits of, and the need for, multilateral cooperation seem to diverge.<sup>14</sup> Since 2003, when WTO members failed to achieve explicit consensus on negotiating modalities for trade and investment and to convert the mandate from the 1996 Ministerial Conference from a study process to a negotiating one, trade and investment is no longer on the WTO negotiating agenda.

#### (b) Services and “servicification”

Based on a study of the Swedish manufacturing sector, Kommerskollegium (2010a; 2010b) has identified a trend of the “servicification” of manufacturing. In particular, the study identifies two developments. First, it notes that purchases of services account for an increasing share of a manufactured product’s total cost. In other words, manufacturing companies are purchasing more and more services.<sup>15</sup>



**Box E.1: Firm heterogeneity and the political economy of NTMs**

Firm-level evidence shows that a few extremely successful multinational companies account for most of a country's trade (see Section B). In addition, there is conclusive evidence that large firms lobby harder than small and medium-sized enterprises (SMEs) because they can more easily accommodate the fixed costs of political contributions and acquire the necessary information for directed contributions (Bombardini, 2008; Kerr et al., 2011; Sadrieh and Annavarjula, 2005). Consequently, it is necessary to look at the preferences of large firms to decide whether "superstar" exporters create tensions for the multilateral trading system. Since the early 2000s, the development of various firm models has made it possible to explore the effects of differences in firms on the political economy of trade.

Trade opening has two opposing effects on domestic firms within the same industry. First, the cost of exporting decreases, which allows more firms to export and increases the sales of established exporters. Secondly, competition increases, which harms domestic firms. Which of these channels dominates for an individual firm depends on firm characteristics, such as size. As a result, lobbying competition arises not only between sectors but also within sectors in which some firms benefit and some lose due to trade. This effect might especially arise in the context of fixed costs because they raise entry costs and thereby shield existing producers or exporters from competition.

Abel-Koch (2010) analyses domestic non-tariff measures and their effect on the fixed costs of exporting for foreign firms. She makes a distinction between NTMs which affect only foreign competitors (e.g. customs procedures) and NTMs that affect all firms equally (e.g. labelling requirements). The former only reduce competition and, therefore, benefit all domestic firms. The latter reduce profits of all firms but also protect the most productive firms from domestic and foreign competition. Consequentially, they are opposed by SMEs but promoted by large firms and might therefore be introduced despite their welfare-reducing impact because these large firms lobby more than SMEs.

A number of factors determine the degree of lobbying competition within an industry. According to Osgood (2012), key determinants are the degree of reciprocity, the mode of trade opening (NTM vs. tariff), country-specific characteristics such as market size, and the degree of product differentiation. As in Abel-Koch (2010), he shows that the least and most productive firms oppose more open trade when it comes to a reduction of NTMs because the competition effect outweighs the sales effect. It is the firms close to the export cut-off, i.e. those that just break even taking into account the costs of exporting, which benefit from trade opening and support it. Osgood (2012) uses these results to explain a persistent feature of trade policy, namely the reluctance to accept opening trade in homogeneous goods.

The emergence of supply chains exacerbates the issue and might weaken reciprocity in trade negotiations. Gulotty (2012) states that as the largest firms are engaged in global production networks, they support NTMs to protect their foreign affiliates. The mechanism is similar to the one described above: multinational affiliates have fewer problems to overcome fixed exporting costs compared with less productive competitors. Hence, large firms promote NTMs not only to reduce domestic competition but also to shield their foreign affiliates from export competition. One implication of the argument in Gulotty (2012) is that market access based rules of reciprocity might be insufficient to address the distributional effects of NTMs because reciprocal tariff concessions cannot account for them.

Overall, these theoretical studies suggest that while the largest firms benefit from tariff reductions, they may not support the reduction of NTMs that have an effect on fixed costs. Large firms can more easily pay the sunk costs of adapting products to different specifications and benefit afterwards from less competition. Trade opening in combination with firm heterogeneity amplifies this problem because it shifts even more resources to large producers that might promote the use of NTMs.

Secondly, the study finds that services account for an increasing amount of manufacturing firms' sales. Put differently, manufacturing firms are selling more and more services.

According to Kommerskollegium (2010a; 2010b), these developments mean that trade in services and trade in manufacturing are becoming more interdependent. Services negotiations and an improved regulatory environment are increasingly important to

manufacturers. More information on these inter-linkages as well as a better understanding of the position of manufacturers in services negotiations is needed. From the WTO's perspective, the challenge is to move away from the current situation in which opening trade in services and goods are discussed separately, with commitments in one area traded against commitments in the other. Instead, the negotiations should be viewed as a "package", reflecting the increasing importance of services for

the manufacturing sector. Finally, the study argues in favour of persuading the manufacturing sector of the importance of being more engaged in services negotiations given how such negotiations can affect their competitiveness.

The internationalization of supply chains and the rapid advance of technology — especially the emergence of the internet — have brought important challenges in terms of the coverage and application of the General Agreement on Trade in Services (GATS). First, in a context where production-sharing arrangements are increasingly internationalized, the consequences of definitional uncertainties surrounding the status of “contract manufacturing” operations under the currently used classification system may increase in importance (Adlung and Zhang, 2013). Such uncertainties could prompt companies to (re-)define the ownership conditions of otherwise identical production activities, with a view to achieving cover under the GATS rather than the GATT disciplines.

Secondly, as Tuthill and Roy (2012) note, services that once could only be provided through a foreign commercial presence (mode 3) can now be provided remotely. New services have also emerged thanks to advances in technology. These developments have given rise to questions about how certain services are to be classified in WTO members’ schedules of commitments. Given that technological change is unlikely to slow down, this uncertainty is something that will continue to affect GATS commitments in the future, be they prior commitments or new ones.

It has been suggested that the principle of “technology neutrality” applies under the GATS. Application of this principle would mean ensuring a level playing field for all services irrespective of the technological platform used to deliver them (Weber and Burri, 2013). WTO dispute settlement rulings relating to the GATS would seem to be consistent with the application of this principle. In the cases “US – Gambling” and “China – Audiovisual Services”, GATS commitments were found to be applicable to electronically delivered services. Technological developments may also affect the characterization of a service. A new “integrated” service may be found to exist as a result of the bundling of several services, as was the case in “China – Electronic Payment Services”. Therefore, technological progress will continue to raise challenges in relation to the GATS framework, either with respect to the classification of a service or to other matters that affect the agreement’s coverage or application.

### (c) Natural resources

Demand for natural resources is increasing, leading to frictions in their markets (see Sections B.2 and C.4). Resource-poor countries wish to secure access to the resources they need, while resource-rich countries

restrict access to their resources – for example, through export taxes. WTO rules were not drafted specifically to regulate international trade in natural resources. This has arguably led in some cases to regulatory gaps, or at the very least to a lack of clarity about how precisely the rules apply in the particular circumstances that characterize natural resources trade. This raises a number of challenges.

One challenge is to manage the regulatory failures implicit in beggar-thy-neighbour policies. As discussed in the 2010 *World Trade Report* (WTO, 2010), the economic theory of trade agreements shows how two large countries acting non-cooperatively may restrict their exports to each other and thereby end up in a “Prisoners’ Dilemma” situation, whereby acting in pursuit of their own best interests does not ultimately result in the best outcome.<sup>16</sup> Because export taxes are the mirror image of tariffs, it is not surprising that the same terms-of-trade argument for international cooperation that applies to import tariffs also applies to export taxes. A large country can improve its terms of trade at the expense of its trading partners by imposing export restrictions. The reduction in supply will push up the world price. As in the tariff case, two large countries restricting their exports to each other could end up in a suboptimal situation if they did not cooperate. If this is the case, a trade agreement that allows trading partners to commit to export tax reductions would be beneficial.

Another set of challenges arises from growing concerns over the sustainability of the management of certain natural resources. Certain subsidies can secure better management of a resource or of environmental damage associated with its extraction and use. Questions have been raised about how such subsidies would be treated under WTO rules, particularly in the light of the different rules that apply to agricultural and industrial goods. Other areas where existing WTO rules interact with conservation policies include domestic regulations and the design and implementation of intellectual property rights.

The 2010 *World Trade Report* (WTO, 2010) also explains how certain domestic and trade measures are subject to different disciplines, even though they have the same economic impact. Given the geographical concentration of natural resources – and hence the fact that resource-scarce countries depend on imports for much of their supply and resource-rich countries export nearly all their production – cases arise where trade measures are close substitutes for domestic regulatory measures. In these cases, regulating the trade measure to achieve undistorted trade in natural resources is a necessary but not sufficient condition. For instance, a consumption tax in an importing country may be equivalent to an import tariff. A production restriction in a resource-rich country may have the equivalent effect to an export restriction. Similarly, an export tax has effects comparable to a



domestic subsidy in terms of the consumption of the resource. In the presence of such equivalence, there is no economic basis for regulating these policies differently.

An additional challenge is to improve the regulation of beggar-thyself policies. As noted in the 2010 *World Trade Report* (WTO, 2010), a measure might be beneficial in the short run, possibly for political economy reasons, but might carry significant long-run costs. This would be the case, for example, with a subsidy provided in connection with the exploitation of a resource that has unrestricted access. Another example is that in the absence of international rules on investment, resource-rich countries may be exposed to the “hold-up” problem, whereby parties do not cooperate for fear of losing their bargaining power. Improved investment disciplines could help these countries improve the credibility of their policies towards investments as they underwrite a commitment to agreed-upon rules.

The 2010 *World Trade Report* (WTO, 2010) also highlights that a narrow understanding of WTO obligations in the area of transit could exclude from their scope transport via fixed infrastructure, such as pipelines, and create regulatory uncertainty. This uncertainty can have consequences for access to supplies of resources.

Finally, the 2010 *World Trade Report* (WTO, 2010) notes that many aspects of natural resources are regulated by international rules outside the WTO. A continuing and growing reliance on natural resources in the world economy, the exhaustibility of those resources and the need to mitigate the negative spillover effects relating to their exploitation and consumption are challenges that can only be effectively confronted through international cooperation and better global governance.

Another issue in regard to primary commodities relates to food prices and food security. Current WTO disciplines on trade in agricultural products were drafted at a time of surpluses and declining prices. The focus was on reigning in the domestic farm policies of industrial countries. The last decade, in contrast, has been characterized by growing demand and higher real prices for many agricultural commodities.<sup>17</sup> In this context, most developed countries have been reducing support and protection to their agricultural sectors, and many have been shifting to more decoupled, less distorting measures. Nevertheless, support remains significant and a considerable share of it is delivered in ways that distort competition and trade.

Agricultural prices have not risen smoothly and progressively. Agricultural markets went through several episodes of high and volatile prices. These episodes raised serious concerns regarding food security in a number of food-importing developing

countries. These concerns were reinforced by the trade policy responses of a number of food exporters who took measures to restrict their exports. Developing and emerging economies seem to be less confident that trade is a reliable source of food supplies. This raises a challenge for the WTO. Confidence in trade as a mechanism that can contribute to food security needs to be reinforced. As explained by Josling (2012), WTO rules allow policy responses when prices fall but do not help much when prices are high. They constrain export subsidies and bind tariffs but do not limit export taxes. As with natural resources, negotiations aimed at binding export taxes could deliver mutually beneficial outcomes. In addition, there may be a need to adjust the rules to ensure that the new measures taken by governments to mitigate the risks associated with high price volatility are not used in a protectionist manner.

The emergence of new agricultural products such as biomass for ethanol and biodiesel, one of the most significant developments in agricultural trade, is also raising a number of challenges.<sup>18</sup> Domestic biofuels markets are often protected from international competition (Josling, 2012). Ethanol, which is classified as an agricultural product, is subject to higher tariffs than biodiesel and mineral fuels (Moreno Caiado, 2011; Yanovich, 2011). Various subsidy programmes are in place providing support to producers of biofuels or consumers (Moreno Caiado, 2011).

Questions have also been raised concerning the different subsidy rules applicable to agricultural and industrial products. Concerns relate not only to the trade-distorting potential of some of these subsidies but also to the lack of transparency (Josling, 2012). In addition, the consistency with the national treatment obligation and the WTO's Subsidies and Countervailing Measures Agreement of mandates requiring the blending of biofuels with mineral fuels has been questioned.<sup>19</sup> Domestic policies incorporating life cycle analysis have given rise to discussions about the appropriateness of differentiating products by methods of production (Josling, 2012).

#### (d) New players and small players

As discussed in Section E.1, a major development that has affected the world trading system is the emergence of new trading powers. The question arises as to whether and how the addition of new countries to the world trading system as a result of accessions to the WTO or the growing role of other countries as a result of economic development may affect global trade governance. At the other end of the spectrum, there is some evidence of an enduring marginalization of the smallest and poorest economies (see Section B.2). Addressing this marginalization is considered by many as a key challenge for the multilateral trading system.

Understanding precisely how changes in the geography of trade affect governance in this area is not straightforward. Many commentators somewhat superficially establish links between changes in the number of WTO members or their relative size and the “crisis” of the multilateral trading system. However, few studies rely on an analytical framework to link a specific cause, such as the change in the geography of trade, to a specific problem affecting WTO governance which could explain the failure to conclude the Doha Round. In this sub-section, efforts are made to embed the discussion of the governance challenges raised by the emergence of new trading powers and the enduring marginalization of the poorest members in a broad analytical framework.

### (i) *New players*

Several commentators have discussed the rise of emerging economies and the evolution of their role in the WTO. Most of them focus on China, India or Brazil.<sup>20</sup> They examine these countries' conduct in the GATT/WTO and on this basis try to predict how they will behave in the future. They document how an increase in their share of trade has translated into increased influence in the WTO and confirm that there are now more players at the table and that there is greater variety among the major players. However, they do not shed much light on the effects of these changes on trade governance.

Other commentators have focused their attention on the reasons behind the stalemate of the WTO negotiations. While most of them mention the size and variety of WTO membership as a possible factor that could explain deadlocks, they typically find that other factors have played a more important role. Odell (2009) examines the reasons that lay behind the deadlock at the 1999 Ministerial Conference in Seattle and the breakthrough agreement at the 2001 Ministerial Conference in Doha. His analysis suggests that the negotiation process among delegations played a crucial role. In his view, the different strategies and tactics employed by negotiators and mediators explain the difference in outcomes.

Wolfe (2010) conducts a counterfactual analysis of the various explanations that have been offered for the failure of the July 2008 ministerial meeting in Geneva. He concludes that emerging players did not contribute much to the impasse which, in his view, resulted from the fact that the ministerial meeting was a failed attempt to accelerate the negotiations process (“sprint during a marathon”). Other contributions suggest that the problems of the DDA and of the WTO are part of a broader systemic malaise which stems from profound shifts in geopolitics (De Joncquières, 2011).

The idea that the larger and more diverse WTO membership challenges decision-making in the WTO is intuitively appealing, even if the precise reasons why

this should be the case have not been spelled out clearly. According to Low (2011), for example, the rise of new powers has placed the “practice” of consensus decision-making under greater strain, and this is reflected in the growing difficulty of reaching decisions and closing negotiations. The underlying reasoning is that consensus can be interpreted as a hidden system of weighted voting, since larger countries find it easier to influence implicit voting outcomes than smaller ones (Low, 2011). As has been argued by a number of commentators, some emerging economies have acquired the status of *de facto* veto players, while some developing countries have improved their negotiating capacity and shown that they can exert an influence on decisions (Elsig and Cottier, 2011; Narlikar, 2007; Odell, 2007).

Theoretical approaches that provide a rationale for trade agreements offer interesting insights into the impact of emerging new trading powers. An early contribution in this area was made by Krasner (1976). He analyses the linkage between particular distributions of potential economic power, defined by the size and level of development of individual states, and the structure of the international trading system, defined in terms of openness. He argues that while a hegemonic system (in which one dominant player holds sway of smaller states) is likely to lead to an open trading system, a system composed of a few very large but unequally developed states is likely to lead to a closed structure. Since Krasner, however, the open economy politics literature has been largely silent on how the rise of emerging powers in the 21<sup>st</sup> century is affecting international economic relations (Lake, 2009).

On the economic side, recent research by Bagwell and Staiger (2012) examines the conditions under which multilateral trade negotiations could deliver trade gains to developing countries in light of the economic theory of trade agreements. If the problem being addressed by international trade negotiations is the terms-of-trade driven Prisoners' Dilemma that arises when governments can shift a portion of the cost of their trade protection on to foreign trading partners by depressing foreign exporter prices, then the main benefit from trade negotiations may only be available to large countries. If this is the case, the growth of some developing countries should not raise problems; rather the contrary.

As argued by Bagwell and Staiger, however, there may be a problem with the increased participation of emerging economies related not to size, numbers or diversity but to timing, i.e. a “latecomers” problem. Over the last 60 years, developed countries have negotiated deep reductions in their tariff commitments on manufactured goods while, as a result of the exception to the reciprocity principle that has been extended to them in the form of “special and differential treatment”, developing countries have committed to fewer tariff cuts in multilateral negotiations.<sup>21</sup> Special and

differential treatment was meant to ensure that developing countries would free ride on the MFN tariff cuts that developed countries negotiated with each other.

Bagwell and Staiger (2012), however, show that because a country's own tariff cuts stimulate its exports, what you get in a tariff negotiation is what you give. This has two important implications. First, it means that without reciprocity, tariff negotiations did not deliver meaningful trade gains to developing countries – and are unlikely to do so now or in the future. Secondly, the WTO may now face a “latecomers” problem as developed and emerging economies attempt to negotiate further tariff cuts. Developed countries may have preserved an inadequate amount of bargaining power with which to engage developing countries in reciprocal bargains. In addition, a kind of “globalization fatigue” may be present in the developed world, whereby the existing MFN tariff levels of developed countries may be too low for a world in which developing countries are fully integrated into the world trading system. In other words, the politically optimal tariffs of developed countries may be higher in today's globalized world than they were in the early 1980s.

### (ii) *Small players*

A major challenge for the WTO, but one that is not new, concerns differences in power and the participation of smaller and poorer developing countries.<sup>22</sup> A number of changes have already been introduced since the creation of the WTO, with the aim of improving the representation of smaller and poorer developing countries. Views differ on whether such changes have been sufficient (Deere-Birkbeck, 2011). A number of proposals aimed at further improving the representation of smaller and poorer developing economies in the WTO are discussed in Section E.3.

A question that arises is whether the emergence of a number of new large traders among developing countries and the resulting increase in diversity among those countries have changed the situation of the smaller and poorer countries. As explained above, the economic theory of trade agreements suggests that the situation may have changed for emerging economies but not for small economies. The central component of the benefit of trade negotiations may now be available to the former, especially if the “latecomers” problem can be addressed. According to this theory, “what you get is what you give” and the large countries, because they are the ones which adopt unilateral trade policies that are the most internationally inefficient, should negotiate the most substantial tariff bindings and get the largest benefits.

For the developing countries that are truly “small” in their relevant markets, however, the emergence of some new large players should not have changed the

situation dramatically. Theory suggests that, with no influence on the terms of trade, they should not be expected to offer tariff concessions in a trade agreement; therefore, the central benefit from negotiations may not be available to them. As explained by Staiger (2006), in the light of the theory, their role in the WTO is essentially to prevent the bigger countries from discriminating against them as these bigger countries use the WTO to find solutions to their problems. The needs and expectations of small developing countries with regard to the WTO may thus diverge from those of the big developing countries. This suggests that the current treatment of developing countries as a single group, notably in the context of special and differential treatment, may not be optimal.

## (e) Developments in the policy context

### (i) *Public policies*

Higher incomes, together with a growing awareness of health, safety or environmental issues, have led to an increase in the demand for regulations aimed at protecting consumers, or at addressing climate change or the depletion of natural resources. At the same time, non-tariff measures related to domestic public policies have become a major source of concern for both firms and governments, a trend that is likely to continue in the near future.

The 2012 *World Trade Report* (WTO, 2012b) discussed a number of challenges raised by the proliferation of public policy related non-tariff measures. First, non-tariff measures raise a transparency issue. The quantity and quality of information available on the prevalence of such measures and on their effects is insufficient. For the WTO more specifically, the priority is to improve the functioning of existing transparency mechanisms.

Secondly, while regulations do not necessarily restrict trade, regulatory divergence can result in important trade frictions. This raises the question of how and where regulatory convergence should take place. This is a challenging dilemma given the trade-off between respecting differences in national preferences and exploiting the efficiency gains from regulatory convergence. For the WTO, one question that arises is whether the existing deeper integration provisions in the Technical Barriers to Trade (TBT) Agreement and the Sanitary and Phytosanitary Measures (SPS) Agreement ensure sufficient regulatory convergence to maximize the gains from trade while allowing governments to pursue their public policy objectives. There is tension, for instance, between encouraging the use of international standards and respecting members' fundamental right to adopt and implement their own domestic standards. Choosing not to adopt international standards, while legitimate, may reduce the incentive for international cooperation on, and negotiation of, such standards.<sup>23</sup>

A third challenge identified in the 2012 *World Trade Report* (WTO, 2012b) is the difficulty of drawing a line between those measures that should be allowed and those that should be forbidden. In particular, what relevance and weight should be given to the rationale or purpose of a measure when assessing the extent to which it discriminates against the imported product. Finally, concerns have been raised in the WTO – mainly by developing countries – regarding the fact that private standards are proliferating, that they are sometimes more stringent than government regulations and that there is no recourse to discipline them. The growing predominance of private standards as systems of governance in global agri-food systems in particular is attracting considerable attention.<sup>24</sup> The question that arises is whether there is a role for the WTO in addressing these problems and, if so, what this role should be.<sup>25</sup>

At the very least, the WTO may be called upon to decide whether a measure is a private standard or a government regulation subject to the TBT Agreement, as was the case in a recent dispute (“US – Tuna II (Mexico)”). Along similar lines, regulation arising from other international organizations, such as the World Health Organization (WHO) which may advocate policies regulating food that is otherwise safe under the SPS Agreement (e.g. to reduce obesity), raises the issue of coherence. This will be discussed in more detail below.

### *(ii) Distribution and labour-market related concerns*

As discussed in Section D.1, in many countries, rising labour market tensions and growing income inequality are adversely affecting public attitudes towards globalization and trade. If trade is perceived by a majority of voters as causing unemployment and/or increasing inequality, governments could refrain from pursuing further trade opening and may even be tempted by protectionism. This creates obvious challenges for the WTO.

With regard to increased pressure for protectionism, there is some evidence that the WTO has played a significant role in recent years in preventing a protectionist backlash (Wolfe, 2012). WTO rules and governments’ commitments, together with reinforced monitoring mechanisms, may account at least in part for the limited protectionist reactions to the crisis. One problem that may arise in the future is if governments turn to measures that are currently undisciplined or untested by WTO rules. Pressure on the WTO to impose or apply disciplines in new areas would increase, as is the case now with regard to exchange rate misalignments. Another possibility would be for governments to use more intensively public policies for protectionist purposes. For reasons discussed in the 2012 *World Trade Report* (WTO, 2012b), this may lead to an increase in the number and the complexity of disputes.

With regard to trade negotiations, focusing exclusively on the efficiency effect of trade opening may no longer be possible. Distribution and labour-market effects will also need to be considered and accompanying measures may need to be proposed in order to win the support of a majority of voters for open trade. Although most accompanying measures fall outside the remit of the WTO, mechanisms available under the WTO to facilitate adjustment, such as implementation periods and flexibilities, may have a role to play.

### *(iii) Need for more coherence with other international institutions*

Trade interfaces with many other policy areas, such as macroeconomic policy, intellectual property, environmental protection, health and employment. In some of these policy areas, there are well-developed multilateral regimes, while in other areas multilateral cooperation is more incipient and institutional frameworks are less developed. The challenge facing the WTO – and the global community more broadly – is maintaining coherence between WTO trade regulations and initiatives and non-trade regulations and initiatives in other multilateral fora. Although the fragmented, decentralized and non-hierarchical nature of the international system makes the pursuit of coherence particularly challenging, fragmentation has the advantage of allowing for experimentation as different policies can be tested at the bilateral, regional and multilateral levels.

To the extent that the actors in other fora are states that are also members of the WTO, the risk of incoherence should be low. Nevertheless, the membership of other multilateral fora does not always coincide with the WTO’s membership. Furthermore, some multilateral fora also include participation by non-state actors. Even when the membership is the same, weak coordination at the domestic level can result in incoherence at the international level.

WTO Director-General Lamy (2012) observes that attempts have been made to narrow the “coherence gap” that currently exists in the international system by establishing links between international regimes, yet these remain weak. In the case of the WTO, he contrasts the relatively strong links with the intellectual property regime administered by the World Intellectual Property Organization (WIPO) and the weaker links that currently exist between the WTO and the environmental regime, the relatively outdated links with the International Monetary Fund (IMF) and the almost non-existent links with the International Labour Organisation (ILO).

As discussed in Section D.3, until the financial crises of the 1990s and 2000s, trade finance, which serves as the “grease” of the trading system, was taken for granted. However, these crises created distortions in the trade finance market which made policy



interventions necessary. In this context, cooperation between multilateral institutions and other stakeholders turned out to be of crucial importance. The joint effort to ensure continued access to trade finance for all firms, large and small, in all countries involved the IMF, the World Bank, the Bank of International Settlements, regional development banks, the International Chamber of Commerce Banking Commission and others.

As explained in Section D.3, persistent exchange rate misalignments are a “systemic irritant” for international trade because they fuel perceptions of unfair monetary competition and create pressure to use trade policy measures to redress perceived monetary imbalances. Although this underscores the importance of an international monetary system that promotes exchange rate stability and adjustment, progress in monetary cooperation has been uneven. A number of institutions and policy processes are in place to enforce better surveillance of exchange rates and reduce global imbalances (see Section D.3). However, the question arises as to whether these will be used to set up a more cooperative system of exchange rates at the international level, and what role the WTO will play in this system.

The need to maintain coherence between the trade and environmental regimes was recognized in the 1994 WTO Decision on Trade and the Environment and in a number of environmental discussions (e.g. the 1992 Rio Declaration on Environment and Development). This objective was recently reiterated at the 2012 Rio+20 Summit, where it was agreed that green economy policies should “[not] constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade, avoid unilateral actions to deal with environmental challenges outside the jurisdiction of the importing country, and ensure that environmental measures addressing trans-boundary or global environmental problems, as far as possible, are based on an international consensus” (United Nations General Assembly, 2012: 10).

Another area where there is a growing interface with the WTO is health regulation. For example, the WHO has adopted a Framework Convention on Tobacco Control and pursues a number of other related tobacco control policies. The WHO is also developing a global strategy to reduce the harmful use of alcohol (WHO, 2010). Domestic measures relating to tobacco control are discussed frequently in WTO committees and have been the subject of dispute settlement proceedings. Similarly, domestic measures relating to alcoholic beverages are increasingly being raised as specific trade concerns in the WTO TBT Committee.

The WTO, WHO and WIPO recently released a joint study examining the interplay between public health, trade and intellectual property, and how these policy

domains affect medical innovation and access to medical technologies (WHO-WIPO-WTO, 2013). As Lamy (2013) explains, the 2001 Doha Declaration on the Trade-related Aspects of Intellectual Property Rights (TRIPs) Agreement and Public Health “helped catalyse the growing understanding that access to medicines requires the right mix of health policies, intellectual property rules and trade policy settings, and involves the judicious and informed use of a range of measures including competition policy, procurement strategies, attention to tariffs and other trade related drivers of cost, and choices within the IP system.” Sustainable solutions will require coherence between these rules and policies.

WTO members have acknowledged the importance of a set of internationally recognized “core” labour standards – that is, freedom of association, no forced labour, no child labour and no discrimination at work (including gender discrimination) but have significant disagreements on establishing linkages between trade and labour issues in the WTO. At the 1996 Singapore Ministerial Conference, WTO members defined the WTO’s role on this issue, identifying the ILO as the competent body to negotiate labour standards. While there is no work on this subject in the WTO’s councils and committees, there is a mandate for collaboration and exchange of information between the WTO and ILO secretariats. This mandate was reaffirmed at the 2001 WTO Doha Ministerial Conference. In line with this mandate, the WTO and ILO secretariats have conducted several research projects. The most recent is a joint study that examines the various channels through which globalization affects jobs and wages in developing and developed countries and discusses how trade and labour market policies can be designed to make globalization socially sustainable (Bacchetta and Jansen, 2011).

The interface of the WTO and other multilateral regimes often touches on contentious issues on which countries hold widely divergent views. The lack of multilateral consensus on such issues makes coordination more difficult. For example, Bernstein and Hannah (2012) see few prospects for coordination between the WTO and the IMF on broader macroeconomic policies given the disagreement between countries on exchange rates and imbalances. The interface between the trade and environmental regimes offers other examples. For instance, Cosbey (2012) worries about the lack of agreement over what is appropriate behaviour in the pursuit of a green economy.

As a result, policy-makers face uncertainties about the legality of the policy tools at their disposal. Countries’ implementing measures do not consider the impact of such measures on their trading partners, and countries resort to measures that may be inconsistent with their WTO obligations. There are a growing number of WTO disputes involving measures relating to environmental



goods or policies. The challenge of securing agreement is made more acute by the need to resolve difficult questions about the effectiveness of different policies and their impact on trading partners, the answers to which depend on a number of factors, such as the technology involved, the characteristics of the sector and the markets at issue.

Fragmentation is not only horizontal but also vertical. Under a model of “multi-level governance”, which was originally developed in the context of European integration, policy-making can take place at many different levels (international, national and various sub-national levels) and involve diverse actors (including non-state actors) (Cottier et al., 2011). While these additional layers of governance – and the resulting policy dispersion – can better target policies and encourage policy experimentation, they can also make coordination more difficult.

Peel et al. (2012) provide an illustration of multi-level governance at work in the environmental context and discuss the coordination challenges that it raises. They note that as multilateral discussions under the auspices of the United Nations Framework Convention on Climate Change (UNFCCC) falter or progress slowly, environmental policy is steadily advancing in a “bottom-up” approach. Such an approach is likely to result in a wide, diverse and increasing array of environmental policies being pursued at both the national and sub-national levels. Some of these measures will have an impact on trade. Without some kind of agreement at the multilateral level, the trade impact of these national or domestic measures is likely to lead to frictions between WTO members and may eventually result in formal disputes being brought to the WTO. Therefore, Peel et al. argue that some mechanism for coordination and evaluation of different regulatory policies – most likely situated at a “higher” level of governance – will be required if multi-level governance in the environmental area is to realize its potential.

### 3. What could the WTO do to address the challenges?

This section reviews a number of proposals that would address the challenges identified above. The proposals are grouped under three headings: WTO agenda; governance and institutional reform; and the role of the WTO in global governance.

#### (a) Review/expand the agenda of the WTO

Previous sections of this report have explained how the trade debate has moved beyond traditional market access issues – a shift that is likely to continue into the future. Over the years, the GATT/WTO's reach has progressively extended beyond traditional border concerns to grapple with the trade effects of “inside

the border” measures.<sup>26</sup> The following sub-sections discuss the traditional issues and the new issues before examining several proposals for how the WTO's negotiating function can be improved to make it possible to move forward more quickly on all of these concerns.

#### (i) *Multilateralizing preferential tariffs*

There is broad agreement among commentators that the challenges arising from the growing number of preferential trade agreements must be high on the agenda of the WTO. Section E.2 made a distinction between the issues raised by “deep” integration agreements, which focus mostly on regulatory convergence, and those raised by shallow integration agreements, which focus mostly on preferential tariffs. This sub-section examines the latter while proposals addressing the former are discussed in subsequent sub-sections.

The successful completion of an ambitious multilateral tariff reduction package is often mentioned as the most effective means of overcoming any negative effects resulting from the proliferation of preferential tariffs (Lamy, 2009). The logic of this is that as MFN tariffs approach zero, the relevance of any preferential tariff treatment disappears (Suominen et al., 2007).

In the absence of an agreement to further reduce MFN tariffs, proposals have focused on preferential rules of origin (i.e. laws, regulations and administrative procedures which determine a product's country of origin) which are often blamed for exacerbating the “spaghetti bowl” effect of preferential trade agreements (PTAs). A decision by a customs authority on origin can determine whether a shipment falls within a quota limitation, qualifies for a preferential tariff or is affected by an anti-dumping duty.

Suominen et al. (2007) explain that there are basically two concerns over rules of origin: restrictiveness and divergence. Rules of origin that are restrictive can result in trade barriers between PTA members and non-members.<sup>27</sup> Divergent rules of origin across PTAs can increase transactions costs to firms which have to conform to different rules. Proposals to reduce the trade distortive effects of preferential rules of origin generally involve harmonization of the rules of origin, convergence and/or some kind of cumulation (Baldwin and Thornton, 2008; Suominen et al., 2007).

Harmonization is technically and politically difficult, and it could result in increased restrictiveness (Suominen et al., 2007). Convergence would imply unification of PTAs with overlapping membership into a single cumulation zone with common rules of origin. Achieving this would not only require negotiating common rules of origin but also the elimination of tariffs for any bilateral relationships within the zone where this had not already taken place. The risk of

convergence is that there is a natural tendency for large cumulation zones to erect more restrictive rules of origin (Suominen et al., 2007). This could lead to the segmentation of markets. In other words, convergence would increase trade among the members of the expanded cumulation zone but reduce trade with non-members.

The optimal approach, according to Suominen et al. (2007), would be what they call a “cap-con” strategy that combines convergence with multilateral limitations – or “caps” – on preferential rules of origin. Gasiorek et al. (2007) propose an alternative approach that would involve using a value-added criterion for determining origin, combined with full cumulation. This approach, however, is not without difficulties. For one thing, variations in exchange rates could mean that an imported product qualifies for origin one year but not the next.

While some of the actions foreseen in these proposals would have to take place at the PTA level (bottom-up), several proposals see the need for a complementary top-down approach in which the WTO could have a central role (Baldwin and Thornton, 2008). The WTO would be a natural forum for the negotiation of harmonized preferential rules of origin if a decision were made to undertake such negotiations. The WTO’s current agenda already includes non-preferential rules of origin, though admittedly these negotiations are taking longer than originally agreed. The WTO would also be the logical forum for discussions of a multilateral “cap” on preferential rules of origin which would supplement the convergence process foreseen in Suominen et al.’s (2007) “cap-con” proposal. Some even see a role for the WTO guiding or encouraging the convergence process at the PTA level (Baldwin and Thornton, 2008). The process ultimately could be taken one step further. The WTO would serve as the forum for the full harmonization of PTA rules of origin.<sup>28</sup>

### *(ii) Breaking the market access impasse*

As explained in Section E.2(d), the emergence of a new group of large trading powers raises a “latecomers” problem. Bagwell and Staiger (2012) make some suggestions on how “latecomers” could be accommodated and, more generally, how developing country members could be better integrated into the world trading system. They argue that the “latecomers” problem could be addressed through negotiated reductions in agricultural export subsidies. This reduction could be used both as a bargaining chip by developed countries and as a device to mitigate the overall trade effects of integrating developing countries into the world trading system by ensuring trade volume gains for developing country members.

More generally, Bagwell and Staiger (2012) argue that if developing countries want to draw any benefit from market access negotiations, they need to move away

from their focus on achieving non-reciprocal special and differential treatment. In markets where they are large players, they could benefit from reciprocal negotiations with each other and with developed countries. Only by “finding ways to harness reciprocity as a means to achieve meaningful market access commitments for emerging/developing economies” (Bagwell and Staiger, 2012: 25) will negotiators break the current stalemate in the Doha Round and deliver substantial trade gains for developing countries, the fundamental objective of the negotiations. This idea may not be as incompatible as it seems with the majority view that SDT is crucial in achieving the goals of the WTO membership as a whole but that it needs a revision (Mitchell and Voon, 2009).

When ministers launched the Doha Round in 2001, they mandated a review of all special and differential treatment provisions, “with a view to strengthening them and making them more precise, effective and operational.”<sup>29</sup> However, as explained in the Warwick Commission Report (Warwick Commission, 2007), one of the main reasons why these provisions need to be operationalized is because they did not adequately reflect the differences among developing countries in the WTO. Along the same lines, Pauwelyn (2013) argues that treating all developing countries as a single group for all matters is neither effective nor equitable. In his view, special and differential treatment provisions do not say that all developing countries must be treated alike, even less that no developing country should ever shoulder any responsibility. More differentiation among developing countries could serve to advance the underlying objectives of these provisions.

Economic theory suggests that an important distinction should be drawn between small and large countries, especially with regard to non-reciprocity. Mitchell and Voon (2009) review some key proposals from economic and legal scholars for operationalizing special and differential treatment provisions and assess members’ progress on this issue in the Doha negotiations. It is worth noting that the trade facilitation negotiations have moved beyond a traditional “one-size-fits-all” approach to special and differential treatment to consider a more tailor-made country-by-country opt-in approach with provisions for technical assistance.

Another challenge is to ascertain the value of WTO tariff commitments when there is so much “water” between applied and bound tariff rates. Messerlin argues that “the real gold mine in the Doha negotiations is the increased certainty that would flow from large cuts to bound tariff rates” (Messerlin, 2008). From this perspective, economists’ recent efforts to assess the value of tariff bindings – and the related costs of tariff “uncertainty” – are encouraging (Bacchetta and Piermartini, 2011; Beshkar et al., 2012; Pierce and Schott, 2012).

*(iii) Responding to the proliferation of NTMs*

As discussed in the 2012 *World Trade Report* (WTO, 2012b), although a coordinated effort of all international organizations active in the trade area will be needed to shed more light on non-tariff measures (NTMs), the WTO should play a lead role in this effort. The efficiency of existing transparency mechanisms, and in particular notifications by WTO members, needs to be progressively enhanced. In the case of notifications, this means that both the quality of the information collected and compliance with notification requirements need to be augmented. The key to success may involve changing members' incentives to abide by their notification obligations. The WTO will also need to refine the "tests" that are currently used to distinguish between legitimate and protectionist measures (WTO, 2012b).

Addressing NTMs may also require deeper rules among countries. At the multilateral level, only the SPS and TBT agreements include such provisions, mostly in the form of strong encouragement to follow existing international standards, and even these can create tensions. The 2012 *World Trade Report* (WTO, 2012b) discusses these tensions and explores the scope for expanding multilateral cooperation on NTMs. Differences in regulatory preferences among countries – together with differing capacities to influence desired outcomes – has meant that regulatory convergence has so far largely taken place at the regional level. However, some deep provisions in PTAs can be discriminatory and create conflicts with the multilateral trading system. In the years to come, WTO members may have to examine whether existing provisions ensure the right balance between international commitments and domestic flexibility in setting NTMs, and whether there is a need for multilateral disciplines to ensure better regional and multilateral convergence.

A number of commentators have argued that there may be scope for multilateralizing deeper PTA commitments to help ensure their coherence with the multilateral trading system.<sup>30</sup> Using a methodology developed by Horn et al. (2009), the 2011 *World Trade Report* (WTO, 2011a) lists the commitments in deep PTAs signed by the United States, the European Union and Japan, making a distinction between, on the one hand, areas of deeper PTA commitments that fall under the current WTO mandate (such as trade in services, customs cooperation, TRIPS, trade-related investment measures (TRIMS) or government procurement) and, on the other hand, areas that fall outside of the current WTO mandate (such as competition policy or investment rules).<sup>31</sup> The dataset also indicates whether or not measures are legally binding. Measures in the areas of services, TRIPS, TRIMS, customs cooperation, intellectual property rights, investment and the free movement of capital are the ones most consistently included in the relevant

PTAs. Baldwin (2012b) suggests that these measures, which can be thought of as those necessary for supply chain trade, should be addressed by the WTO. Several of these issues are discussed in more detail below.

The above list should certainly not be seen as exhaustive. Baldwin (2012b) suggests that government procurement, visa requirements, labour and environmental issues – which only some outsourcing countries include in their agreements – are among the issues that the WTO will be under growing pressure to address. Plans currently under way for so-called "mega-regional" trade agreements also reveal negotiating priorities. According to press reports (*Inside US Trade*), the Trans-Pacific Partnership negotiations, for example, have produced a draft chapter on regulatory coherence. Another proposal is to require parties to conduct regulatory impact assessments when developing new regulatory measures. These assessments would examine whether a policy objective requires new regulations or can be met by non-regulatory or voluntary means. They would also examine the costs and benefits of each available alternative and provide an explanation of why one approach is superior to another, including the scientific, technical, economic or other grounds on which the decision was based. While the draft chapter is a negotiating document that may not reflect the views of all participating countries, it has attracted significant public criticisms from a number of non-governmental organizations.

*(iv) Services*

The "servicification" of manufacturing (whereby the distinction between services and manufacturing is becoming blurred), the internationalization of supply chains and the proliferation of domestic services regulation all pose challenges to the WTO. In order to better address servicification, it has been proposed that manufacturers' interests be taken into account in WTO services negotiations and that services and goods negotiations should not take place along separate tracks, with trade opening commitments in one area traded against commitments in the other.

As regards the internationalization of supply chains or the proliferation of public policies, proposals have focused on increasing transparency, limiting the discrimination resulting from regional integration and ensuring the appropriate level of regulatory convergence at the multilateral level (WTO, 2011a; 2012b). As a first step towards greater regulatory cooperation, Hoekman and Mattoo (2011) propose developing a "services knowledge platform" – that is, a forum which would encourage a substantive, evidence-based discussion of the impact of domestic regulation and identify good practices.

Regarding services value chains specifically, some observers have called for a reform of the normative

framework, thus providing a firmer basis for modal neutrality in the GATS and strong provisions on competition policy and regulatory coherence (Drake-Brockman and Stephenson, 2012; Stephenson, 2012). Another proposal is to adopt a “whole of the supply chain” approach (Hoekman, 2012), which would involve complementing the negotiations on trade facilitation and regulatory convergence with new negotiations on logistics, thus bringing together a variety of services sectors and subsectors that are relevant to logistics.<sup>32</sup>

One issue that has gained prominence in the light of production fragmentation is the cross-border movement of people. The GATS includes commitments on market access and national treatment regarding the temporary movement of natural persons in services sectors. Nonetheless, several studies have shown that while all WTO members have undertaken such commitments, they are typically extremely shallow (see WTO document S/C/W/301).

#### *(v) Investment*

Investment is not strictly speaking a new topic. The link between trade and investment has been recognized for some time. Trade and investment allow firms to specialize in producing what they can produce most efficiently. Trade allows an economy to specialize in production and then to exchange it for the goods and services imports its nationals want to consume. Foreign direct investment allows capital and technology, including organizational, managerial and marketing skills, to move to where it can be used most efficiently (WTO, 1996).

The original plans in the 1940s for an international institution for trade, to be known as the International Trade Organization, foresaw the establishment of multilateral investment disciplines. Several WTO rules (such as the GATS, the TRIPS Agreement and the Government Procurement Agreement) place important obligations on governments with respect to the treatment of foreign nationals or companies within their territories (WTO, 1996). The GATS mode 3 commitments (foreign commercial presence) are often described as obligations that address foreign investment in the services sector. A WTO Working Group on Trade and Investment was established in 1996. The Group undertook analytical work until 2004, when members decided not to proceed further with the topic of investment in the Doha Round negotiations. Efforts to negotiate multilateral investment disciplines were also undertaken in the Organisation for Economic Co-operation and Development (OECD).

The literature on global supply chains has brought a renewed focus on the importance of the link between trade and investment rules (Baldwin, 2011b). Furthermore, some of the other trends identified in this

report are mirrored in the field of investment. There has been a diversification of the geography of investment flows and investment law. Emerging economies have become capital exporters and flows of investment between developing countries are rising (see Section C.2). The number of bilateral investment treaties between developing countries has also been growing in recent years, especially in relation to China, India and Japan (Schill and Jacob, 2013). Investment rules, moreover, are increasingly being incorporated in preferential trade agreements, and regional rule-making is gaining importance (UNCTAD, 2012).

The fragmentation and complexity of investment rules means that there are still calls for a multilateral initiative that can promote coherence, although this need not necessarily take the form of binding rules (UNCTAD, 2009). Indeed, the “more pluralistic universe” of international investment agreements reflects a desire for differentiated solutions while at the same time reflecting recurrent principles and a degree of standardization (Schill and Jacob, 2013). Ultimately, there would appear to be a need for new research on how some of the trends discussed in this report affect the case for multilateral rules on investment and more specifically for the negotiation of such rules in the WTO.

#### *(vi) Competition policy*

Like investment, discussions of the relationship between competition policy and trade go back to the birth of the multilateral trading system and were most recently the subject of analytical work in a working group established in 1996 and discontinued in 2004. Several provisions in the WTO agreements reflect the importance of ensuring the competitive operation of markets in what Anderson and Holmes (2002) describe as an “ad hoc integration” of competition policy and concepts into the multilateral trading system. Examples of competition-related provisions in WTO agreements include Article 11.3 of the Agreement on Safeguards, Article 40 of the TRIPS Agreement and the Reference Paper adopted as part of the negotiations on basic telecommunications services.

Anderson and Holmes (2002) summarize the case for and against incorporating a multilateral framework on competition policy into the WTO. The case in favour takes the view that competition policy and trade opening pursue the common objectives of economic efficiency and consumer welfare, and that a lack of competition can undermine the gains from trade opening. The case against questions whether competition policy and trade opening can be approached within the same operational framework, especially given the WTO's focus on market access. However, Holmes and Anderson suggest that, just before WTO competition policy discussions were discontinued, there was a shift in proposals away from



a “hard law” approach focused on developing a harmonized code of competition law towards a “soft law” approach that would see WTO members adhere to certain core principles and modalities for cooperation.

As with investment, competition policy is frequently covered in “deep” preferential trade agreements, albeit not necessarily through binding rules (Baldwin, 2012b; WTO, 2011a). Disciplines on competition policy have also been mentioned in the trade literature as an example of the type of disciplines that facilitate supply chain trade (Baldwin, 2012b). This suggests a need for further research on how current and future trade trends identified in this report affect the case for multilateral rules on competition policy, and for future negotiations in the WTO.

### *(vii) Disciplining export duties*

Another NTM-related issue identified for possible inclusion in the WTO's agenda is export restrictions. This issue has gained more prominence in recent years because of concerns over food and natural resources scarcity.<sup>33</sup> As discussed in Section E.2, binding WTO commitments on export duties could be mutually beneficial. As with all trade negotiations, trade-offs would be possible in a wider context – and not only among members applying such measures. For example, reductions in export taxes on natural resources could be exchanged for reductions in import tariffs on higher value-added products, especially when these involve tariff escalation, i.e. higher import duties on increasingly processed goods.

As noted in the 2010 *World Trade Report* (WTO, 2010), WTO rules prohibit the use of quantitative export restrictions (with some exceptions) but there are no equivalent restrictions on export duties. WTO members are free to make binding commitments to reduce export taxes but most have not (several countries have recently committed to “schedule” export duties in the context of their WTO accession). Proposals to discipline export taxes have been tabled in the Doha negotiations although discussions of these proposals showed divergent interests among members. Export taxes have also been discussed in the Doha agricultural negotiations. There is also a G20 initiative to limit export restrictions on food items destined for food aid. At the regional or bilateral level, a number of PTAs prohibit the application of export taxes or other measures of equivalent effects.

### *(viii) Energy and climate change*

Concerns over climate change and environmental degradation more generally have moved to the forefront of the multilateral agenda in recent years and are expected to remain there for the foreseeable future. Cottier (2012) notes that until relatively recently, international law developed and operated

under the assumption that natural resources were endless and bountiful. That assumption is now viewed as manifestly incorrect. It is hardly surprising that climate change and environmental sustainability have gained greater prominence within WTO debates as well. Of particular concern are trade policies related to energy sectors and energy security (WTO, 2010).

Different approaches have been proposed to ensure coherence between WTO rules and climate change mitigation measures. Under one approach, the WTO would remain focused on trade measures, while policies relating to climate change mitigation would be discussed in the proper multilateral fora, such as the United Nations Climate Change Convention. The problem with this approach is that it is difficult to see how the WTO can avoid these issues, at least in the medium term. Whether adopted unilaterally or multilaterally, members whose trade is affected by climate change mitigation measures (for example, border tax adjustments or subsidies for renewable energy) may seek to challenge them in the WTO. If the WTO were to rule against such measures, it could be characterized as obstructing climate change solutions. Similar issues could arise with other environmental measures.

Others see a more positive and constructive role for the WTO. Esty and Moffa (2012) emphasize the importance of managing ecological interdependence alongside economic interdependence. For example, they see the WTO as playing a supporting role alongside a new Global Environmental Organization, ensuring that gains from economic integration are made available only to those who share the burdens of ecological interdependence. For Esty and Moffa, incorporating environmental issues more fully into the international trading system is also the correct normative approach because economic efficiency and environmental sustainability are mutually reinforcing and interdependent. Absent this approach, the WTO risks a backlash against further economic integration.

Cottier et al. (2011) argue that existing WTO rules are inadequate to deal with the challenges specific to the energy sector, and that a new comprehensive sectoral agreement on energy is needed to promote energy security and climate change mitigation policies. This sectoral agreement would include, among other things, clarification of how WTO subsidy rules apply to the energy sector. As a preliminary step, members would need to collect more information on subsidies provided to the energy sector by establishing a committee responsible for examining whether each member's energy subsidy notifications sufficiently represent the level of support in the sector. Once reliable data are collected, members would be given a deadline to prepare and submit a national roadmap in which they would commit to phase out environmentally harmful energy subsidies. The subsidy-watch committee could play a role in identifying environmentally harmful



subsidies and time lines for phasing them out. The proposed sectoral agreement would also resolve the problem of fragmentation resulting from different energy activities being classified under separate GATS schedules.

Because the energy industry is a chain of interconnected activities, Cottier et al. (2011) argue that service operators in the sector need a coherent set of market access rights. Members should identify core and related energy services to facilitate making additional commitments in the energy sector. Finally, the sectoral agreement would include some modification of the Government Procurement Agreement to make the recognition of climate-related measures more explicit. Instead of a member proving that its environmental policies fall under an exception to the Government Procurement Agreement, a member challenging these policies would need to demonstrate that the policies were discriminatory or unrelated to climate change.<sup>34</sup>

#### *(ix) Exchange rates and macroeconomic policies*

Some commentators argue that undervalued currencies have effects equivalent to both an import tax and an export subsidy, and propose that the WTO should be used to regulate exchange rates. Mattoo and Subramanian (2009b), for example, favour creating new WTO rules on exchange rates that would be parallel to those on export subsidies and import taxes. They propose using the WTO dispute settlement mechanism to enforce these rules, with the IMF providing inputs on technical matters. Other suggestions include a WTO plurilateral agreement on exchange rates (including IMF participation), allowing participating members to file a complaint against another member if the latter's currency was seriously undervalued against a relevant basket of currencies for a prolonged period of time (Hufbauer and Schott, 2012). Eventually this could lead to tariff retaliation.

As argued by Marchetti et al. (2012), addressing the challenges raised by exchange rate misalignments and global imbalances involves addressing a "coherence gap" in global governance. These authors argue that WTO-triggered trade actions should form part of a broader solution but that trade rules alone cannot provide an efficient instrument to compensate for the weaknesses in international cooperation in macroeconomic, exchange rate and structural policies. They discuss the potential role for multilateral trade cooperation in the three traditional areas of the WTO: market access negotiations, rule-making and dispute settlement.

As regards market access, Marchetti et al. (2012) suggest that market opening in services, particularly in financial services, could reduce some of the policy-related distortions and market imperfections that lead to the build-up of unsustainable imbalances. With respect

to rule-making, they note that the first-best solution is international cooperation on macroeconomic, exchange rate and structural policies. They nevertheless recognize that sanctions could play a role to deter countries from either free-riding or defecting from the cooperative outcome. However, they make clear that sanctions should apply to both surplus and deficit countries. Furthermore, they consider that other policies which also contribute to imbalances would have to be subject to international scrutiny and suggest that penalties would have to go beyond trade sanctions. Finally, in relation to dispute settlement, Marchetti et al. underline the difficulties in identifying currency manipulation and in establishing the trade effects of exchange rates.

#### **(b) Governance reforms**

Since the creation of the WTO in 1995, debate on the need to reform its governance has been intense (Hoekman, 2011), with proposals covering the "legislative", "executive" and "judicial" functions of the WTO. The arguments in favour of institutional reform are diverse – sometimes even contradictory – reflecting the wide range of objectives and concerns of the various stakeholders in the trade regime. Moreover, because of the Doha Round stalemate, proposals have increasingly focused on the WTO's legislative function. Since reviewing all these proposals is clearly beyond the scope of this report, it examines instead some of the main proposals in the light of the challenges identified in Section E.2.

It has been argued that the rise of emerging economies and therefore the increasing number of veto players in the WTO is straining the practice of consensus decision-making (see Section E.2(d)). Many proposals for reforming the WTO's decision-making procedure focus not on abandoning the consensus norm but on reforming the way it operates.<sup>35</sup> One group wants to keep consensus as the basic principle but to introduce procedural changes that would require blocking countries to explain their actions (2004 Sutherland Report). Another group would replace consensus with weighted voting (Cottier and Takenoshita, 2003) or a "critical mass" approach (Jackson, 2001).<sup>36</sup> Another group advocates an Executive Board or Committee to help steer the broader membership (Blackhurst and Hartridge, 2004; Blackhurst, 2001; Steger, 2009). Finally, a number of proposals envisage a combination of the above measures (Elsig, 2010).

Several of these proposals address not so much the challenge posed by the increasing number of large players in the system but the problem of a small minority of members blocking decisions. While a discussion of the strengths and weaknesses of each proposal is beyond the scope of this report, it is important to note that most commentators are aware of the advantages of consensus decision-making and believe that it should continue to apply in certain circumstances.

A number of the proposals for reforming the WTO's decision-making procedure have devoted specific attention to the decentralized, bottom-up, agenda-setting process of the WTO. These proposals aim at addressing the “endless cycling dilemma” that arises as a result of the absence of any clear institutionalized agenda setting (Elsig, 2010). As summarized in the 2004 Sutherland Report, the WTO system suffers from “a proliferation of back-seat drivers, each seeking a different destination, with no map and no intention of asking the way” (2004: 76). One approach to address this problem that has been proposed is to allocate agenda-setting power to an Executive Board or Committee.

Other proposals have focused on the role of the WTO Secretariat in supporting the decision-making process. The WTO Secretariat and Director-General have limited power, and the idea would be to give them greater power of initiative without diluting the authority of the membership to decide. A study of the role and powers of the various secretariats and heads of international organizations could help trigger discussion and reform in this area.<sup>37</sup>

There are also numerous proposals which focus on the so-called single undertaking approach<sup>38</sup> – i.e. the concept that “nothing is agreed until everything is agreed” in a negotiation – which is another core element of WTO decision-making.<sup>39</sup> As Hoekman (2011) notes, a single undertaking approach has the advantage of creating issue linkages but has the disadvantage of creating a hold-up problem. Several commentators have proposed abandoning the single undertaking and shifting to a variable geometry model (Jones, 2010; Lawrence, 2006a; Levy, 2006; Martin and Messerlin, 2007; Messerlin, 2010). Such a shift, which can also be seen as a way to revisit the consensus rule, would allow sub-groups of members to move forward on an issue while others abstain. One key issue is whether an agreement concluded under a variable geometry approach would apply only to signatories or be extended to other WTO members through the application of the most-favoured nation (MFN) principle.

Variable geometry with MFN typically takes the form of the so-called critical mass approach whereby a sufficiently large subset of the entire WTO membership agrees to cooperate, allowing the remaining members to free-ride. A critical mass approach was used for the post-Uruguay Round agreements on basic telecommunications and financial services as well as for the Information Technology Agreement. Commentators have noted that a form of critical mass approach has typically been used for market access negotiations in the GATT/WTO (Hoekman, 2011; Low, 2011). The proposal is to use the critical mass approach for the negotiation of new or modified rules.

As argued by Low (2011; 2012) and the 2011 *World Trade Report* (WTO, 2011a), a critical mass approach

could also be used to address the challenges raised by preferential trade agreements (see Section E.2(a)). When “deep” integration takes place at the regional level in the form of preferential trade agreements, international trade rules are being negotiated and decided outside of the WTO in a setting where differences in power are greater and the basic principles of non-discrimination and reciprocity are absent. A critical mass approach would make it possible to multilateralize trade rules without involving the entire WTO membership. Low argues that “it could facilitate the adoption of a forward-moving agenda, which under the right circumstances would not compromise the integrity and coherence of the multilateral trading system” (2012: 311). A number of commentators have raised doubts about the additional scope for using a critical mass approach largely because they do not see many areas where it could be applied (Elsig, 2010; Wolfe, 2009).

Variable geometry without MFN can take the form of “plurilateral agreements” – i.e. agreements concluded by a subset of WTO members whose obligations and benefits are not extended to non-participants.<sup>40</sup> Hoekman (2011) observes that a shift to critical mass with MFN does not really imply a change in *modus operandi* and suggests that if/where the non-discrimination constraint can be relaxed, a plurilateral agreement provides an alternative. Hoekman and Mavroidis (2012) make a comparative analysis of the case for trade opening through plurilateral agreements and preferential trade agreements. They conclude that facilitating greater use of plurilateral agreements would be a Pareto improvement (i.e. an action that harms no one and helps at least one party) over the status quo because plurilateral agreements would fall under the WTO umbrella and would be subject to more WTO disciplines than preferential trade agreements.

While plurilateral agreements under the WTO may be preferable to preferential trade agreements outside of the WTO, they clearly impose more stress on the multilateral system than the critical mass approach.<sup>41</sup> The multiplication of such agreements may threaten the integrity of the multilateral system and the core non-discrimination principle. Moreover, once the “insiders” define the rules of the game in a specific area, it will be harder for the “outsiders” to alter the rules if and when they decide to participate.

A concern with most of these proposals is that efforts to increase efficiency may come at the expense of legitimacy. Smaller and poorer countries see the consensus rule as protection against decisions that may be detrimental to their interests.<sup>42</sup> Ismail and Vickers (2011) argue that the consensus rule should not be abandoned but rather strengthened. In their view, consensus and the single undertaking are not responsible for the stalemate of the Doha Round. Instead, they attribute the negotiations' difficulties to the hangover from previous imbalances in negotiating

outcomes, substantive divergences of interests among trading partners, and domestic politics within major players. To address the challenge of small and poor countries' participation, they propose improving the representation of developing country coalitions. With regard to variable geometry and critical mass proposals, Deere-Birkbeck (2011) notes that to date, only a few contributions to this debate seriously consider their implications for small and poor countries.

A key issue that cuts through all of these proposals to improve WTO governance is transparency – and the need to strengthen the functioning of existing WTO transparency mechanisms. For example, there is a broad consensus that the notifications mechanism for WTO members, a core transparency tool, should be improved – and that the key to improving it starts with a better understanding of its weaknesses.<sup>43</sup> There is also a broad consensus that the WTO's trade monitoring exercise has been a success, and that it needs to be continued and strengthened.

With regard to WTO committee work, the role of consultations could be expanded, following the example of the specific trade concerns mechanism of the SPS and TBT committees (Wolfe, 2013). Reinforcing the WTO's surveillance and monitoring functions may involve additional resources.<sup>44</sup> In particular, as suggested in the 2004 Sutherland Report, the WTO Secretariat needs stronger research, analysis and dissemination capacity so it can be a major source of trade and trade policy data, and more effectively support the objectives of the trading system (Hoekman, 2011). Efforts already undertaken in this area should be sustained.<sup>45</sup>

### (c) What role will the WTO play in global governance?

The existing international system is often described as fragmented, decentralized and non-hierarchical. A number of legal regimes co-exist, reflecting diverse attempts at finding cooperative solutions to common problems. The number of legal regimes is expanding and their degree of specialization is increasing. States remain prominent in the system but new actors are now playing important roles. These new actors include international organizations (such as the WTO), non-governmental organizations, multinational corporations and individuals. Challenges are increasing in complexity and, in some cases, urgency.

The WTO, like the GATT before it, plays a central role in global trade governance. For many years, there has been an intense debate about the potential challenge to the WTO from an ever expanding number of preferential trade agreements (PTAs). This debate has intensified in recent years as the number of PTAs – and the number of members pursuing them – has increased, and as the new PTAs increasingly move beyond preferential tariffs to focus on regulatory

cooperation. An interesting literature has emerged about “multilateralizing” PTAs (both in terms of preferential tariffs and regulatory cooperation) and several proposals have been put forward to this effect.

One of the key trends identified in this report is the emergence of global supply chains. This trend has led to calls for the WTO to focus on issues that are more relevant to supply chain trade, such as trade facilitation, investment, competition policy or the movement of persons. The fact that WTO members are agreeing to new disciplines on these issues in the context of deep PTAs – and possibly “mega” PTAs covering a large share of global trade – has led some to raise alarms about the growing risk of the WTO losing its “centricity” in trade governance. In particular, Baldwin (2012b) notes that the new rules and disciplines that underpin supply chain trade are being written outside the WTO in deep PTAs, bilateral investment agreements and as part of autonomous reforms being carried out by emerging economies. Baldwin also identifies efforts to harmonize some of these new disciplines in the context of mega-regional or -bilateral PTAs that are being negotiated or are under discussion.

In the meantime, the WTO is unable to engage with the new issues raised by supply chain trade because of the Doha Round's lack of progress. In these circumstances, Baldwin predicts that multilateralism will remain strong for traditional trade, but fragmentation and exclusion are the more likely outcomes for supply chain trade, which happens to be the most dynamic sector of international trade. Baldwin believes that at present the WTO is unable to address the current trend of fragmentation and exclusion. Therefore, he proposes the establishment of a second trade organization, which he calls “WTO 2.0”. This organization would have a more limited membership comprised primarily of those countries involved in supply chains. He also proposes a list of issues to be covered based on a review of deep PTAs (see Section E.3(a)).

Baldwin does not explain how these new WTO 2.0 rules would relate to members' existing WTO obligations or how the potential policy frictions arising from the additional layer of rules (applicable to some WTO members, but not all) would be mitigated. He also neglects recent progress under the current WTO framework on the issue of government procurement, where a revised text of the Agreement on Government Procurement has been negotiated and several accession negotiations are actively being pursued.

Baldwin's alarm over the WTO losing “centricity” is not shared by everyone. Lester (2013) argues that global governance may not be necessary on the new supply chain issues that Baldwin proposes be addressed by WTO 2.0. Lester points to autonomous or unilateral reforms adopted by several WTO members and believes that leaving such new issues to domestic

governments is an effective way of encouraging good governance. The reason for this is that governments that fail to attract investment will copy the policies of those who succeed in attracting it. He also asserts that the interest of the business community for more international disciplines on these new issues must be weighed against the opposition from other sectors of civil society who are concerned about the higher degree of intrusion into domestic regulatory autonomy that international rules on such issues would entail.

Turning back to the multilateral trading system, Lester (2013) observes that it may be that the WTO as it currently stands gets the balance right between global trade governance and domestic regulatory autonomy. Consequently, there would not be a need for the WTO to catch up. Instead, the WTO should continue to focus on reducing protectionist trade barriers, while regulation generally should be left to domestic governments.

Recent discussions about the WTO's role in global trade governance have also focused on exchange rate policies. The use of WTO provisions to counteract the effects of currency manipulation – and proposals to give the WTO a more active role with respect to exchange rate policies – are highly contentious and will likely remain so in the coming years.

As the Doha Round negotiations have waned, other functions of the WTO are receiving greater attention and their value to global economic governance is getting more recognition. These functions include dispute settlement, promoting transparency, trade monitoring and surveillance, conducting economic research, capacity building and technical assistance for developing countries (see Section E.3(b)). WTO Director-General Lamy has referred to the need to fill in the WTO's "missing middle" – that is, the sphere of activity that lies between negotiations and dispute settlement.<sup>46</sup> This involves scaling up the WTO's trade surveillance activities, capacity building and the day-to-day technical work that is critical to strengthening the system's foundations. The WTO took an important step in this direction when it implemented the trade monitoring mechanism in the wake of the global financial and economic crisis that began in 2008.

The information collected and provided by the WTO on trade measures and policy has long been recognized as a public good. Yet for some, it is a public good that is currently under-provided, particularly with respect to non-tariff measures and measures relating to services (Hoekman, 2012). As explained, efforts to enhance the information supplied by the WTO would have to include stronger notification obligations for WTO members. It could also include giving the WTO Secretariat more scope for analysis of the information collected. For example, it has been suggested that more could be done with the information collected under the PTA transparency mechanism. This

information could be used by members to learn from each other's experiences with PTAs and to explore ways to incorporate into the multilateral trading system the trade opening achieved through PTAs (GMF/ECIPE, 2012).

Current trends indicate that the WTO is likely to continue to play a key role in the peaceful settlement of trade disputes. While all PTAs have their own dispute settlement mechanism, there is little, if any, evidence that they are eroding the relevance of the WTO's dispute settlement mechanism. On the contrary, an important share of disputes brought to the WTO are between PTA partners (WTO, 2011a). With a few exceptions, PTA dispute settlement mechanisms show little use to date.

There are reasons to believe that non-tariff measures will make up an increasing share of disputes brought to the WTO, and a good proportion of those disputes will involve measures that touch on public policy issues, such as health, consumer safety and the environment (WTO, 2012b). As noted in Section E.2, distinguishing between measures that pursue legitimate public policies and measures that are protectionist is seldom straightforward. These measures, moreover, raise difficult questions about the degree to which the multilateral system should defer to members' regulatory autonomy or regulatory preferences. International consensus on proper policies can both simplify and complicate matters. Some WTO agreements, such as the SPS Agreement and the TBT Agreement, assign a privileged role to international standards. However, in other contexts, the reliance on international norms agreed outside the WTO is more contentious. This issue acquires an additional layer of complication when the international norm is one to which not all WTO members have consented.

It is unrealistic to believe that the WTO can stand aloof from broader issues of global governance beyond trade and economic policy. Many non-trade measures have trade effects and, for that reason, can fall within the purview of the WTO. At the same time, there are pressures to use trade policy to further non-trade goals, such as the protection of the environment or the promotion of labour standards.

A few commentators see a more ambitious role for the WTO in framing the discussions on global governance. Chaisse and Matsushita (2013) propose using the Trade Policy Review Mechanism (TPRM) to collect information about, and to promote harmonization and coordination between, PTAs, to promote convergence of climate mitigation measures, and to coordinate policies on other matters. They see advantages to using the TPRM because its reports are non-binding and because it could operate as an informal network of government authorities. Chaisse and Matsushita, however, do not explain why similar discussions could

not take place within the WTO committees dealing with the specific subjects, namely the Committee on Regional Trade Agreements and the Committee on Trade and the Environment. Their preference may have to do with the WTO Secretariat's role preparing detailed reports for each trade policy review.

Messerlin (2012) would like to see members take advantage of the WTO's institutional and substantive capacity as a forum for a broader discussion of global governance. These discussions would go beyond trade and would cover other issues where multilateral cooperation is facing difficulties, such as climate change, water and fisheries. Messerlin proposes that the WTO host a series of worldwide, "totally open-minded" conferences on all of these related issues. He suggests that such conferences would reveal the deep similarities and the converging interests among these various world communities struggling for functioning multilateral governance.

Regardless of whether the WTO takes on a more prominent role in global governance, its relationship with other specialized international regimes will remain a key issue in global governance debates. Coherence among regimes is an elusive objective. Although there is a growing recognition that the WTO cannot remain oblivious to developments in other regimes, there are diverse views about the extent to which the WTO (and its rules) should interact with those regimes.



# Endnotes

- 1 For a detailed discussion, see WTO (2012b).
- 2 As discussed elsewhere in this sub-section, Blanchard (2010) makes a similar but more general point.
- 3 In some cases, PTAs deepened and locked in unilateral tariff reductions, further reducing the perceived risk of future tariff increases.
- 4 Note that from the perspective of the terms-of-trade theory of trade agreements, unilateral tariff cuts would most likely leave the terms-of-trade motivated component of tariffs in place and therefore would not affect the chances of success of further tariff negotiations.
- 5 Tariff reductions in the context of WTO accession, which can be viewed as unilateral, are bound.
- 6 See the overview of the literature in the 2011 *World Trade Report* (WTO, 2011a).
- 7 Areas where regulatory convergence is needed include investment, capital flows, intellectual property protection, competition policy, services trade, and industrial standards and regulations. See the 2011 *World Trade Report* (WTO, 2011b).
- 8 The positive association between deep integration and production networks is confirmed by empirical analysis (WTO, 2011a).
- 9 See Orefice and Rocha (2011).
- 10 Note, however, that a large number of PTAs contain so-called "GATS-minus" elements which are disconnected from and difficult to reconcile with WTO obligations (Adlung and Miroudot, 2012).
- 11 See the discussion in WTO (2011a).
- 12 Ciuriak et al. (2011) point at another difference between deep integration at the regional and at the multilateral level. While heterogeneous firms trade models suggest that more importance should be granted to extensive than to intensive margin responses to trade opening, there is evidence suggesting that PTAs have positive effects at the intensive margin and negative effects at the extensive margin, whereas the opposite is true of opening in the multilateral context.
- 13 Note that about two-thirds of the world's FDI stock is in services and that BITs are already covered by GATS disciplines insofar as they affect trade in services and meet the definition of mode 3. Consequently, the relevant provisions are multilateralized by virtue of the MFN clause in GATS Art. II whenever the member concerned has not listed an MFN exemption (Adlung and Soprana, 2012).
- 14 Proponents of a multilateral investment agreement (MIA) have argued that the spread of BITs has created uncertainty, high transaction costs and distortions due to diverging systems of BITs (Brunner and Folly, 2007; Leal-Arcas, 2009; Urban, 2006). However, MFN clauses and other factors within these treaties have caused a degree of coherence that alleviates this problem (Chalamish, 2009; Schill, 2009) and reduces potential gains from an MIA (Bubb and Rose-Ackerman, 2007). In addition, it has been pointed out that despite the alleged divergence of BITs, FDI is rising fast and that BITs allow significantly more flexibility to account for the needs of developing countries (e.g. Hoekman and Saggi, 2000; Kennedy, 2003; Nunnenkamp and Pant, 2003).
- 15 See also Figure B.17 in Section B.2(e).
- 16 It also shows that such a situation may similarly arise as a result of rent-shifting between exporters and importers of natural resources when the latter uses consumer taxes and the former uses production quotas.
- 17 This trend may persist in the longer term in light of demographic developments and constraints in the natural resources sector. See Sections C.1 and C.4.
- 18 More broadly, concerns have been raised about the impact of biofuels on food prices and, consequently, on efforts to fight hunger (United Nations Special Rapporteur on the Right to Food, 2011).
- 19 See Moreno Caiado (2011). See also the complaint brought by Argentina against the European Union and Spain, WT/DS443.
- 20 A number of papers discuss the rise of emerging economies in the multilateral system over time. See for example Lawrence (2006), Arrighi (2007), Narlikar (2007), Jacques (2009), Hopewell (2010), Gao (2011), Mattoo and Subramanian (2011), Subramanian (2011).
- 21 As discussed elsewhere in this report, however, developing countries have considerably reduced their tariffs unilaterally and in PTAs and there have also been significant tariff reductions in the context of WTO accessions, but not on a reciprocal basis.
- 22 See for example the reports by the Consultative Board to the Director-General Supachai Panitchpakdi (2004) (the so-called "Sutherland Report", named after Chairman Peter Sutherland) and by the Warwick Commission (2007).
- 23 For a discussion of the challenges raised by the deep integration provisions of the TBT and SPS Agreements, see the 2012 *World Trade Report* (WTO, 2012b).
- 24 See Henson and Humphrey (2008) and Von Schlippenbach and Teichmann (2012) for example.
- 25 Josling (2012), for example, asks whether the SPS Agreement should be amended to allow government regulation to respond to consumer concerns that have not been found to have scientific merit. While some exporting countries fear that this would make the SPS Agreement a less effective constraint, others are concerned that in the absence of solution the SPS Agreement might increasingly become irrelevant for global food trade as more use is made of private standards. It should be noted that the TBT Agreement allows members to adopt technical regulations to address consumer or environmental concerns.
- 26 The 2007 *World Trade Report* (WTO, 2007) discusses the deepening of the multilateral trade agenda.
- 27 Restrictive rules of origin can also curb preferential trade and end up nullifying the tariff reduction benefits of the PTA.
- 28 There have been initiatives in the past to harmonize rules of origin in the GATT/WTO. An incipient initiative was pursued in 1982, although ultimately members agreed in the Uruguay Round only to launch a work programme on non-preferential rules of origin. Members were unable to complete the work programme by the agreed deadline. More recently, there have been discussions in connection with Generalized System of Preferences (GSP) schemes and duty-free quota-free treatment for LDCs.

- 29 See document WT/MIN(01)/DEC/1, para 44.
- 30 See Baldwin et al. (2009) and WTO (2011a).
- 31 Areas that fall under the current WTO mandate are typically called WTO+ areas, while areas that fall outside of the current mandate are termed WTO-X areas. For a comprehensive list of WTO+ and WTO-X areas, see the 2011 *World Trade Report* (WTO, 2011a).
- 32 Some progress in this direction has been made in the Trans-Pacific Partnership negotiations.
- 33 OECD has compiled a comprehensive inventory of restrictions on exports of raw materials. See <http://www.oecd.org/tad/benefitlib/exportrestrictionsonrawmaterials.htm>.
- 34 It should be noted that a revised Government Procurement Agreement was negotiated after these proposals were made. The revised GPA (and more specifically Article X:6) expressly states that parties may apply technical specifications to promote the conservation of natural resources or protect the environment. Parties to the revised GPA also agreed to initiate a Work Programme on sustainable procurement (GPA/113, Annex E).
- 35 For a discussion of the pros and cons of the consensus norm, see Hoekman (2011) and the references therein.
- 36 The notion of critical mass used in this context is different from the one that refers to the adoption of consensus decisions that involve a subset of large players taking on additional commitments.
- 37 See Kuijper (2009), Elsig (2010) and an address by WTO Director-General Lamy at Bilkent University, Ankara, on 15 March 2013, available at [http://www.wto.org/english/news\\_e/sppl\\_e/sppl272\\_e.htm](http://www.wto.org/english/news_e/sppl_e/sppl272_e.htm). Specifically, WTO Director-General Lamy observes: "In a number of other international organizations, the Secretariat plays a bigger role in leveraging its experience while remaining neutral. It has a 'right of initiative'; in other words, the capacity to table proposals to facilitate negotiations and to broker compromises. In the WTO, that role is virtually non-existent, and when coupled with the need for consensus, can make it significantly more difficult to generate expert solutions to problems".
- 38 Many proposals address several dimensions of the decision-making process simultaneously. See Elsig and Cottier (2011), for example, who list five elements (including consensus and the single undertaking) which they think need to be addressed simultaneously.
- 39 Interpretation of the concept of the single undertaking can differ between commentators. It has been interpreted variously as the "analogue to consensus in negotiations" (Hoekman, 2011), as a simple procedural rule in negotiations (Low, 2011), as one corner of the WTO decision making triangle (Elsig and Cottier, 2011) or as a constitutional metaphor (Wolfe, 2009).
- 40 Only two such agreements are in effect: the Agreement on Government Procurement and the Agreement on Trade in Civil Aircraft.
- 41 See the discussion in Hoekman and Mavroidis (2012).
- 42 See the discussion of the value of consensus to smaller and poorer members in Hoekman (2011).
- 43 See Wolfe (2013); 2012 *World Trade Report* (WTO, 2012b).
- 44 See Hoekman (2011).
- 45 See 2012 *World Trade Report* (WTO, 2012b).
- 46 See for example his 2010 speech entitled "The Doha Round marks a transition from the old governance of the old trade order to the new governance of a new trade order" [http://www.wto.org/english/news\\_e/sppl\\_e/sppl173\\_e.htm](http://www.wto.org/english/news_e/sppl_e/sppl173_e.htm).