Initiative for Policy Dialogue Working Paper Series

September 2005

Founding Principles: The Basis for a Fair Agreement
Andrew Charlton and Joseph E. Stiglitz

Trade

5

Founding Principles: The Basis of a Fair Agreement

One reason the Development Round is faltering is that the WTO (like its predecessor the GATT) has been, by process and structure, a mercantilist institution that has worked on a principle of self-interested bargaining. The concept of a Development Round implies a fundamental departure from the system of mercantilism towards collectively agreed principles. However, there has been almost no discussion, let alone agreement, on what such principles might be. The lack of commonly agreed values has deprived the WTO's members of any means of collectively choosing a set of policies from among competing proposals.

Progress in the Development Round needs to be accompanied by a debate about principles, how those principles apply to trade, and how they should be implemented in the current round of negotiations. In this chapter we make a contribution to this debate by considering several fundamental questions: 'What are the appropriate boundaries for the WTO's agenda?', 'What would constitute a 'fair' agreement?', 'What are the characteristics of a 'fair' negotiating process?' There are no universal answers to these questions, but there are answers that derive legitimacy from commonly agreed values implemented in a democratic process.

We begin with an analysis of the principles that should underlie a development round of trade negotiations. It seems self-evident that:

1. Any agreement should be assessed in terms of its impact on development; items with a negative effect on development should not be on the agenda.
2. Any agreement should be fair.
3. Any agreement should be fairly arrived at.
4. The agenda should be limited to trade-related and development-friendly issues.

These principles may be widely agreed to; however, there may be important differences in the way various terms such as 'fairness' are interpreted and understood and about the meaning of terms and about how to respond to conflicts among the principles.

Impact assessment

Any agreement should be carefully designed to promote, not hinder, development but there is surprisingly little economic analysis of the precise consequences of various potential trade agreements on participant countries. Where analytical studies have been done, they have not penetrated to the core of negotiations and do not seem to play a central role in setting the agenda. The absence of this type of analysis raises the question of what is driving the prioritization of trade issues on the WTO agenda, other than a mélange of prevailing orthodoxies and the momentum of special interest groups.

The WTO Secretariat should be responsible for producing a general-equilibrium incidence analysis, analogous to what is conducted when taxes are imposed, attempting to assess how different countries are affected by different proposals. Publicly available analysis would benefit developing countries, many of which are at an information disadvantage relative to developed countries. Publicly available information would also be an important source for consumers, who are less equipped to lobby for favorable outcomes than producer groups.

Analysis based on general equilibrium models must be sensitive to the fact that different developing countries are likely to be affected differently, and different groups within developing countries are likely to be affected in different ways. Thus, eliminating developed country agricultural subsidies is likely to raise the price of agricultural products, thereby benefiting countries that export these commodities and hurting those that import them. Within individual countries it is likely to benefit the producers of agricultural goods, and hurt consumers. Thus the elimination of subsidies presents a welfare trade-off for developing countries. But the net effect of the elimination of subsidies is likely to be pro-development. Even if net-importing countries experience aggregate losses, the reform has potentially positive distributional consequences within the poor countries since it is the producers (and those rural populations that survive on agricultural production) who are among the poorest communities in those countries. These communities are the most likely to benefit, even if the country as a whole loses because it is a net importer of subsidized commodities.

The results of general equilibrium models are sensitive to their assumptions. Much of the analysis of the impacts (including, for instance, judgments about whether particular types of agricultural subsidies are trade-distorting) relies on a particular model of the economy, the neo-classical model, which assumes full employment of resources, perfect competition, perfect information, and well-functioning markets, assumptions which are of questionable validity for any country, but which are particularly problematic for developing countries.

Most of the tools used to analyse general equilibrium effects of trade liberalization are static models. They describe the movement from one 'steady state' to another but do not incorporate the costs associated with transition or the consequences for economies which are initially out of steady state. For example the models typically assume that there is full employment. Trade liberalization measures are good for a country because they enable resources to be redirected from low-productivity protected sectors to more productive sectors as the economy specializes in their areas of comparative advantage. Under full employment, developing countries would unambiguously benefit from trade liberalization measures, were it not for terms-of-trade effects (changes in relative prices.) Most of the studies cited in Appendix 1 that assess the impact on developing countries thus focus principally on these terms-of-trade effects.

But with unemployment, trade liberalization is not needed to 'release' resources into more productive sectors and trade liberalization may simply move workers from low-productivity protected sectors into unemployment. This lowers the country's national income and increases poverty. There can be multiplier effects, so that the total impact is far greater than the direct effect. Much of the opposition to trade liberalization arises because of the perceived effects on employment. In more developed countries, monetary and fiscal policy should, in principle, enable the country to maintain nearly full employment. As the advocates of trade liberalization repeatedly emphasize, the objective of trade liberalization is not to create jobs, but to increase standards of living by allowing countries to specialize in areas of comparative advantage. But in many developing countries, with persistent unemployment—with unemployment rates sometimes in excess of 20 per cent[1]—it is evident that monetary and fiscal policies are unable to maintain the economy at full employment. While the standard neo-classical models typically deployed to assess trade impacts do not identify the impact of trade liberalization on the equilibrium level of unemployment[2] (by assumption there is none), even if trade liberalization had no impact on the *equilibrium* level of unemployment, it may take the economy considerable time to adjust, and the costs of adjustments—lost income and increased poverty—may be considerable.

Another important assumption made in most of the analyses is that there is no uncertainty, no risk. But *changes in trade regimes affect countries' exposure to risk*. In the absence of good insurance

[1] In 2001 average unemployment rates reached 14.4% in Africa; 12.6% in transition economies; and 10% in Latin America. Such statistics, however, often under-represent the true level of unemployment—for instance, the prevalent high levels of disguised unemployment.

[2] See for instance the papers cited in Appendix 1, especially the contributions by Hertel (1997) and Anderson, Dimaran, Francois *et al.* (2000).

markets, there can be first-order welfare effects arising from this increased exposure to risk.[3] For instance, with a quota, those who compete with imports know precisely how much will be imported, and therefore, if there is relatively little domestic volatility, they will face relatively little price uncertainty. But with the tariffication of quotas, countries are exposed to considerably greater volatility.[4]

It is important that any incidence analysis take into account other pre-existing distortions. For instance, tax policies (often advocated by international institutions), which effectively tax the informal sector less than the formal sector, already distort production in favor of the informal sector. In this context, trade regimes which lower the international price of agricultural goods, typically produced by the informal sector, have a larger adverse effect than would be the case if tax policy were more neutral.

It is also important that any incidence analysis be based on an assessment of the *global general equilibrium impacts*, which takes into account the effects of a change in a trade regime on global relative prices. For instance, if a single small country were to subsidize cotton, it would have a relatively small effect on the global price of cotton. But if a large producer—e.g. the United States—subsidizes cotton, it has an effect on the international price of cotton.

The fact that implementation and adjustment costs are likely to be larger in developing countries, unemployment rates are likely to be higher, safety nets weaker, and risk markets poor are all features of developing countries that have to be taken into account in conducting a relative incidence analysis. If trade liberalization has a large effect on inequality, then governments may be required to strengthen their redistributive welfare system. Larger taxes generate increased deadweight loss, which reduces the efficiency gains from liberalization.

Large adjustment costs imply not only that the process of liberalization should be conducted gradually, but also that there should not be oscillations. Bilateral agreements *on the way to a multilateral*

[3] For instance, Dasgupta and Stiglitz (1977) show that the change from quotas to tariffs may expose countries to much greater risk. Newbery and Stiglitz (1984) show that the adverse effects from increased exposure to risk may be so much greater that everyone in both countries may be worse off.

[4] The incidence, in this case, depends on the extent to which there are disturbances in the domestic markets, and the extent to which the external disturbances are correlated with the domestic disturbance.

agreement may be particularly detrimental when there are important elements of trade diversion. The greater adjustment costs in developing countries may mean that the net benefit (net of the adjustment costs into and out of the sector having temporary preferential treatment) may be small and/or that there will, in fact, be relatively little benefit, as expansion into that sector may be limited as investors recognize its short-term nature.

Finally, it is of the first importance to distinguish between provisions which should, in principle, make a country better off on its own, almost regardless of the circumstances; provisions which might or might not make a country better off on its own; and provisions which essentially are *redistributive* in nature, with the gains to one side being largely offset by losses to the other. We have argued that many of the trade liberalization measures would, in a world of full employment, make a country better off on its own. In the real world, the question is often posed: 'Why is there any need for a trade agreement?' Trade agreements are used only as a bargaining weapon. The threat of not opening up one's own market (which has a cost) is used to force the opening up of the foreigner's markets.

Note that many of the arguments that are currently used in favor of certain provisions of proposed trade agreements contend that they are good for the developing countries.[5] To the extent that such arguments are correct, of course, it implies that there is no need for a trade agreement, other than the *political economy* argument that it is only by bringing to bear the pressure from the gainers from trade liberalization that one can overcome the resistance of the losers in a world in which compensations are typically not made. Moreover, to the extent that such arguments are correct, it implies that (apart from global terms-of-trade effects) the issue of fairness only pertains to the distribution of *relative* gains (relative costs and benefits) since *every country* benefits. It also means that any country could unilaterally increase its gains simply by lowering its trade barriers further, thereby expanding trade. To be sure, some of the opposition against

[5] This includes not only trade liberalization, but also investor protections. Investor protections will attract more investment. But if that is the case, then countries will have an incentive to undertake such actions on their own. There are some legitimate worries, spelled out below: excessive investor protection may compromise general welfare concerns, e.g. about safety or the environment.

trade liberalization comes from those who would be hurt by it, in particular special interests who benefit from protection; but some opposition may arise because particular countries may be adversely affected *as a whole*.

These cases need to be distinguished from intellectual property rights, where stronger intellectual property protections may increase the incomes of those in the more advanced industrial countries *at the expense of those in the less advanced industrial countries*. Here the issue is primarily redistributive, and is accordingly fundamentally different from those that arise in connection with trade liberalization.[6] Again, the developed countries make a self-serving argument that stronger intellectual property protections will (1) induce more research or (2) induce more investment in intellectual-property-intensive industries. But for most goods there is relatively little evidence that the incremental profits generated in developing countries have much impact on research. This is certainly the case for most drugs, where the overwhelming bulk of the profits are generated by sales in the North—the drug companies do little research related to illnesses whose primary incidence is in the South. In many areas, such as soft drinks, trade secrets, not patents, have been the basis of expansion into the South. In any case, again, if it were true that stronger intellectual property protections led to faster growth, countries interested in enhancing growth would provide such stronger protection on their own.

Any agreement should be fair

Article 2 of the Doha Ministerial Declaration contains an implicit principle of fairness: it focuses the Doha Round on the 'alleviation of poverty' in developing countries and recognizes 'the need for all our peoples to benefit from the increased opportunities and welfare gains that the multilateral trading system generates'.

[6] See e.g. Bhagwati (2002), which argues, accordingly, that intellectual property should never have been part of trade negotiations.

Similarly, the analysis in this book is based on a concern for social justice and a degree of equity between nations. There are those that would criticize this premise on the basis that notions of fairness which are fairly well defined in contexts involving individuals are not easily extended to bargaining among collectives such as nation states. That brings us to the crucial question—should international law, the rules and regulations that govern relations among countries and among individuals and firms in different countries, be based simply on realpolitik, or should considerations of social justice and fairness play a role? This is a long-debated subject, and we cannot pretend in this book even to touch on the merits of the alternative positions. We believe that the view that international trade regulations should be governed by *principles* rather than just economic power is at least a respectable one—and one to which the international community has seemingly subscribed. While we accept that the application of principles of fairness is much weaker in the international context than it is inside nations, it is an important exercise to explore the implications of principles of fairness between nations, and that is what we do in this book.

Indeed, as globalization has proceeded, and there has been increasing recognition of the need for global collective action, principles of fairness have increasingly come to play an important role. The fact that principles of equity, just like the principles of democracy, underlying international relations are not precisely defined does not mean that they are not relevant. Just as arguments about equity hold sway in domestic debates, they are also relevant in the international arena. International agreements require the agreement not just of the rich countries, but also of the poor, and if the citizens of democratic poorer countries believe that they are being unfairly treated, they will refuse to comply. Just as information about the distributional impacts of domestic programs has become an important force in shaping legislation in the democracies of the advanced industrial countries, so too can information about the development and distributional impacts of proposed international trade regimes become an important force in the outcome of international bargaining.

Opponents of the view that fairness should be a consideration in trade negotiations often argue that it is unnecessary because trade agreements are voluntary, and so developing countries do not have to sign up to any agreement which they think will make them worse off. And since countries can withdraw from the WTO, the fact that they do not do so shows that they must believe that they are net beneficiaries. Such views almost certainly misconstrue the nature of the power relationship between the developed and less developed countries. The advanced industrial countries are still able to get their way, particularly by withholding aid unless developing countries accept their demands. Moreover, countries may benefit from having the 'rule of law' that the WTO provides for trade between nations—the United States may, for instance, be restrained from the use of its brute economic power but that does not mean that the rules themselves are fair, in any sense of the term. Still, the benefits of trade liberalization may go disproportionately to the richer countries.

Moreover, those who put forth this argument fail to note the difference between individual and group actions. Given that other developing countries had agreed to sign, it might pay any country that is holding out to sign on; but it still may be true that the developing countries as a whole (or a subgroup of these countries) would have been better off if they, as a group, had not signed. (The prisoners' dilemma arises not only in the case of prisoners, but also in the case of poor countries engaged in bargaining with the rich.) Asymmetric trade agreements give rise to terms-of-trade effects—changes in relative prices—which any single country may ignore, but which become significant in a global agreement.[7]

However, although we believe that fairness is an important element of trade negotiations, we do not pretend that it is easy to state precisely its implications for the agreements. Underlying conflicts about perceptions of fairness is the fact that *because the circumstances of the different countries are different, any agreement that applies 'fairly' or 'uniformly' to all countries may still have large differential effects*. This is why we have emphasized the importance of an incidence analysis, an assessment of the differential effects on different countries. *Any agreement that differentially hurts developing*

[7] The poorest developing countries play such a small role in international trade that even though their tariffs may be high, their impact on global relative prices is small. This is not so for the advanced industrial countries.

countries more or benefits the developed countries more (say, as measured by the net gains as a percentage of GDP) *should be presumptively viewed as unfair*. Indeed, it should be essential that any reform be *progressive*, i.e. that a larger share of the benefits accrue to the poorer countries. This was almost certainly not true of the Uruguay Round.

There is one key difficulty in interpreting this requirement. Many of the costs of, say, agricultural subsidies are borne by the developed countries. Not only are there huge budgetary costs associated with the subsidies, but the subsidies distort production, and thus there is an efficiency loss associated with them. Were developed countries to eliminate their subsidies, they would therefore be among the main beneficiaries. Thus, a refinement of the above criterion would look at the benefits granted others: in competitive markets, it would be reflected in the general equilibrium terms-of-trade effects received by producers or paid by consumers; in non-competitive markets (or markets with quota restrictions) it would be the value of access granted.

One particular aspect of this should be emphasized: in trade disputes, *both de jure and de facto*, the more developed countries are in a better position to prevail. For instance, the costs to a developing country of bringing a claim against a developed country or to defend themselves against a claim from a developed country may be very high; in practice the developing country is at a disadvantageous position in any process entailing resort to complicated and expensive legal proceedings.[8]

There is a long history within developed countries of those in positions of power using the legal system to maintain their privileges. More recently, many developed countries have tried to come to terms with the resulting inequities by providing public legal assistance. Typically, because of the relatively low pay of those employed to provide such assistance, this can go only a little way in redressing the imbalance. But at a minimum, the developed countries should

[8] More generally, as we discuss later, the WTO dispute system favors rich countries with the resources to use it effectively for their own interests.

provide financial assistance to less developed countries involved in such legal disputes to create a more level playing field.

By the same token, even were a developing country to prevail in a WTO tribunal against the United States or Europe, the enforcement system is asymmetric, and consequently unfair. The sanction for violating a WTO agreement is the imposition of duties. If Ecuador, say, were to impose duties on goods that it imports from the United States, it would have a negligible effect on the American producer; while if the United States were to impose a duty on goods produced by Ecuador, the economic impact would more likely be devastating. In practice, the WTO system has no effective way of enforcing penalties against an unfair trade action whose main impact is on small developing countries. When, of course, a major industrial country takes a global action then there can be a global response (for example, when the US increased protection on their steel industry, the whole world responded and forced its removal).

But the other side of 'fairness' is *the initial condition*. Currently, developing countries have higher tariffs than do developed countries.[9] The United States might claim that it is only fair that developing countries cut their tariffs proportionately; this would entail a greater amount of tariff reduction by the developing countries—and accordingly the adjustment costs to the developing countries might be greater.[10] But the developing countries also point out that *at the very least* the principle of progressivity should rule out adverse discrimination against developing countries. Yet, currently, the developed countries impose higher tariffs against the developing countries than they do against the developed countries, even taking into account the so-called 'preferences'.

Balancing these concerns are those dealing with historical inequities. If a country's relative weakness in part is due to a colonial heritage, or more pertinently, to earlier unfair trade agreements (e.g. that resulting from the Opium War in the nineteenth century in China), to what extent does fairness and equity demand that current

[9] For manufactured goods average tariff rates are 1.5% for developed countries and 11.5% for developing countries. For agriculture, average tariff rates are 15.6% for developed countries and 20.1% for developing countries (Hertel and Martin 2000)

[10] See Ch. 8 for a discussion of adjustment costs.

agreements not reflect these past injustices? Trade negotiators from the North would like to pretend that such inequities never occurred. Those from the South might argue that one cannot separate events today from the historical context.

The nature of trade agreements is, of course, that not every provision in the agreement is viewed to be 'fair'. Some are intended to give more to one party, others to another party; it is the package as a whole which should be viewed as fair. But each trade agreement is forward-looking: there are implicit and explicit understandings about the direction of future agreements.

Fairness between foreign and domestic producers

While most of the discussion of this chapter concerns 'fairness' *among countries*, there is a related issue: fairness between domestic and foreign producers. One of the purposes of trade liberalization is to ensure that foreign producers are treated 'fairly'. But again there are questions: 'What does fairness mean in this context?' Foreign producers and domestic producers are often inherently in different situations. In the case of a developing country, the foreign producer may have greater access to capital. He almost surely has greater access to international technology. Much of the debate about protection concerns 'leveling the playing field', correcting these initial inequities.

Most of the economics literature eschews the 'fairness' vocabulary in favor of efficiency language. Protecting domestic firms is *inefficient*: the country would be better off if it did not. But for reasons hinted at in the previous section, these arguments are contentious. There may be important learning benefits from protection. And while economists have typically argued in favor of open subsidies and/or government loan programs rather than the hidden subsidies protection provides, direct subsidies may, for a variety of reasons, be difficult or impossible to implement. As we discussed in Chapter 2, in a second-best world, some protection may be efficient.[11]

[11] For a historical argument, see Chang (2002). More recent theoretical analysis includes that of Dasgupta and Stiglitz (1985).

Thus, there is contentiousness in both the efficiency and the fairness arguments. But what cannot be justified in terms of either are developed country non-tariff barriers, such as dumping, which treat developing country producers disadvantageously relative to their own, subjecting them, for instance, to a far higher standard for what amounts to predatory behavior than that to which they subject their own firms.[12]

By the same token, it is hard to justify demanding developing countries to provide *foreign* firms with *greater* protections than provided to domestic firms. While there is some debate about the validity, or abuse, of the infant industry argument, there is no argument for protection of the 'grown-up' industry'.

So too, America has found it desirable to impose lending requirements on its banks to ensure that they provide capital to underserved communities, through the Community Reinvestment Act. Such measures recognize that there is a role for government in encouraging particular sectors of the economy. It seems *unfair* (and inefficient) to preclude developing countries from undertaking similar measures.

Other problems in the interpretation of fairness

One of the most difficult issues is how to treat policy failures within each of the countries. Suppose that it is true (as asserted earlier) that the Uruguay Round in fact differentially benefited the United States. But suppose the imbalance could have been reduced if only the developing countries *reformed* their economies. They might, for instance, have been able to benefit more from the reduction in tariffs on manufacturing if only they had invested more in infrastructure, so that they could have attracted more manufacturing.

By the same token, to what extent should the international trading regime be *blamed* for inequities which arise, in part, because of how other parts of the international system operate? Suppose, for instance, that a 'fair' trade negotiation occurs within the WTO, but

[12] For instance, the US anti-trust laws impose a very high standard for predatory pricing, much higher than is employed in the US fair trade laws which pertain to the actions of foreign firms. Indeed, it has been argued that using the US domestic standard, few foreign firms would ever be found guilty of dumping, but using the dumping standard, most American firms could be found guilty.

that after the trade negotiations are over, the developing country has to turn to the IMF for assistance, and that the IMF imposes further trade liberalization as a condition for assistance. Viewing the two negotiations together, as a package, clearly the developing country may have given far more than it got *within the trade package*, but of course it got, in addition, some foreign assistance. (Admittedly, in the case of many of the bail-outs, the primary beneficiary of the bail-outs may be banks in the more advanced industrial countries.) But even apart from these demands that are put on developing countries, the United States makes demands on other countries (Section 301 and Super 301 actions[13]), to which they often feel compelled to accede.

Similarly, when international institutions encourage tax policies which have the effect of distorting production towards the informal sector, it implies, as noted above, that the West's subsidies of agriculture have a greater adverse effect on the developing countries than they otherwise would have had. In talking about the inequities of the trade regime, should we assess its fairness coming on top of distortions imposed or encouraged by the North, or in terms of what the incidence would have been had a more neutral tax system been imposed? Should we view the two actions together, assessing the incidence of the two policies in conjunction, or should we only assess the fairness of the trading regime itself?

By the same token, when countervailing duties are imposed against a developing country which has 'subsidized' interest payments, by bringing them down from the usurious levels insisted upon by the IMF to levels still slightly higher than in international capital markets, is this unfair? Should the government only be viewed as undoing a distortion? The problems are exacerbated by demands (included in the recent bilateral trade agreements between the United States and Chile and the US and Singapore) for capital market liberalization. Capital market liberalization increases economic volatility,[14] and the increased economic volatility increases the risk premium that investors demand,[15] effectively

[13] Super 301 authority—which expired in 1997 but was reinstituted in January 1999—enables the US Trade Representative to identify the most significant unfair trade practices facing US exports and to focus US resources on eliminating those practices.

[14] See, for instance, Prasad, Rogoff, Wei *et al*. (2003) and Stiglitz (1999*a*, 2001, 2004)

[15] See Stiglitz (2003).

increasing the interest rate charged. It seems unfair to force upon the developing countries provisions which effectively increase the interest rate they have to pay, and then, when the government tries to undo the consequences, to slap a countervailing duty upon them.

In the South, there is a propensity to see such actions as coordinated, pushed by special interests in the North. While they may see more coordination than actually occurs, the impacts are often closely akin to what they would be if they were coordinated. The high interest rates, tax policies, and trade liberalization policies demanded by the IMF do exacerbate the adverse effects on developing countries of whatever trade liberalization measures they agree to within the WTO. The two cannot be seen in isolation. This provides the basis of one of the important recommendations that we make below.

With such disparate views of fairness, it is no wonder that the South may feel that a trade agreement proposal is grossly unfair, and yet the North might feel no pangs of conscience. Some might conclude that, as a result, we should simply drop the criterion of equity as a desideratum of a Development Round agreement. That would be a mistake. In a democracy, any trade agreement must be freely entered into, and the citizens of the country must be persuaded that the agreement is essentially *fair*. Moreover, there are several widely accepted philosophical frameworks—in particular that of John Rawls[16]—which at least provide some guidance for thinking about whether any agreement is fair.

Any agreement should be fairly arrived at

Procedural fairness becomes an important complement to the kind of fairness discussed in the preceding section (where fairness is judged in terms of the outcomes) when there is some ambiguity

[16] See Rawls (1971). Rawls's method generates basic principles of justice that provide some guidance in evaluating the fairness of particular trade agreement proposals—in particular, his 'Difference Principle', that 'Social and economic equalities are to be arranged so that they are . . . to the greatest benefit of the least advantaged' (Rawls 1971: 83). For alternative frameworks (which in the current context would arrive at quite similar views) see Sen (1999).

about what should be meant by 'outcome fairness'. Procedural fairness focuses on the openness and transparency of the negotiation process, and the manner in which the discussions are conducted. It is hoped that the outcomes that are achieved through fair procedures are more likely to be fair, though, of course, even an open and transparent bargaining process is likely to result in 'unfair' outcomes when the parties to the bargaining are of markedly different strengths. But it should be clear: a fair agreement is unlikely to result from an unfair process.[17]

Transparency is essential because it enables more voices to be heard in the negotiating process and limits abuses by the powerful. This is particularly important for developing countries, because of the limited size of their negotiating teams. Of particular concern is the lack of transparency of the negotiations. In the Uruguay Round the developed countries negotiated via the infamous 'green room' methods, in which only a few chosen countries from the developing world engaged directly in negotiations with the United States and Europe. The 'Green Room' process has now been formally abandoned but the ongoing negotiating practice continues to place the developing countries in a disadvantageous position because of the complexity of the negotiations and their limited staffs.[18] Procedural fairness needs to deal with the asymmetry of power and the asymmetry of information among WTO members. While the effects of power disparities are difficult to reduce, informational disadvantage can be remedied.[19]

The WTO's Dispute Settlement System also lacks procedural fairness in some important ways. In trade disputes, the system favors developed countries both *de jure* and *de facto*. Thus, the costs to a

[17] There is now a large literature which establishes that setting the agenda may have a large effect on the outcome; hence having a voice in the setting of the agenda is essential. The agenda in previous trade negotiations has been unbalanced. This is evidenced by the fact that issues of benefit to the developed countries have been at the center of the discussion. Issues like liberalization of unskilled labor-intensive services have been off the agenda, while liberalization of skilled labor-intensive services have been on it. Since the bargaining process affects the outcome of the bargain, the WTO needs to ensure that the process has clear rules that ensure the effective participation of the weakest players.

[18] See for example the open letter, dated 6 Nov. 1999, sent by 11 developing countries to the WTO chairman Ambassador Ali Mchumo of Tanzania, expressing their concern over the lack of transparency in the WTO green room process.

[19] Both increased transparency and the provision of (impact assessment) information, discussed in Ch. 5, reduce information asymmetries.

developing country to attack a claim of intellectual property by a Western company in a case involving bio-piracy may be very high. In practice the developing country is at a disadvantageous position in any process entailing resort to complicated and expensive legal proceedings. Thus the WTO dispute system favors rich countries with the resources to use it effectively for their own interests. The EC, Japan and the US were complainants in almost half (143 of 305) of all bilateral disputes in the WTO Dispute Settlement system between 1995 and 2002. By contrast the 49 members classified by the UN as Less Developed Countries did not bring a single challenge in that period.[20]

Since January 1995, WTO members have brought 302 disputes to the WTO for resolution under the Dispute Settlement Understanding (DSU), far outstripping the rate at which disputes were dealt with under the GATT. Moreover, the dispute settlement system operated under the GATT was rarely used by developing country members, and thus the new system has been reformed in an attempt to increase participation from all members. In some areas there has been significant progress. The DSU has reduced the length of proceedings, leading to more timely 'trials', introduced automatic adoption of reports to remove the potential for a recalcitrant defendant to block a ruling, and increased the consistency of rulings through review by the appellate body. Taken together, it has been predicted that these reforms would create a system in which, unlike in the GATT years, 'right perseveres over might' (Lacarte-Muro and Gappah 2000), and which would therefore entice developing countries to bring more cases to the WTO than they did to the GATT.

However, the increasingly legalistic process has raised the transaction costs of settling disputes (Busch and Reinhardt 2003)[21]—one factor that has contributed to the ongoing under-representation of LDCs in the process. With the exception of Nigeria, which participated as a third party in the United States–Shrimp dispute, and the Afro-Caribbean Pacific (ACP) countries, which participated as third

[20] See Horn and Mavroidis (2003).

[21] Welcome reforms have been implemented to prevent powerful defendants from delaying cases. In particular, procedures and terms of reference have been standardized. One unforeseen consequence of this is that it has increased the importance of the quality of the legal preparation before the case is heard and, in some cases, increased the cost of initiating a case.

parties in the European Communities–Bananas dispute, no African country and no other least developed country has participated in proceedings before the appellate body to date. This imbalance in participation is also reflected in the outcomes of disputes. Whereas developing country complainants have increased their success rate under the WTO rules (the proportion of times defendants fully liberalize disputed measures)—up from 36 per cent of cases under the GATT to 50 per cent under the WTO—developed countries have been even more successful—their success rate rose 40 per cent under the GATT to 74 per cent under the new regime (Busch and Reinhardt 2003).[22]

The low participation rates of developing countries and the imbalanced outcomes are partly a consequence of the asymmetry of the final punishment mechanism. The final punishment mechanism is triggered if the defending country continues to fail to comply with a ruling after a 'reasonable period of time' for implementation.[23] In this event the complaining country may initiate action to seek authorization to 'suspend concessions or other obligations'. In practice this has involved complainant governments imposing 100 per cent *ad valorem* tariffs on a list of products from the target country. However, in the seven episodes where action was, authorized, the complaining government actually performed the act in only three instances and in each case the imposing government included a large country.[24] This

[22] Moreover 17 of the 24 WTO-era *developing* country complaints yielding full concessions came from the wealthiest and most dominant developing countries (Argentina, Brazil, Chile, India, South Korea, Mexico, Singapore, and Thailand). See Busch and Reinhardt (2003).

[23] DSU, art. 21.3.

[24] This happened in Bananas, when the United States raised tariffs against the EC, and in Hormones, when the United States and Canada raised tariffs on EC goods. For example, in Bananas, the United States imposed 100% tariffs on the European Communities on a list of products that included, among others, handbags and electrothermic coffee-and tea-makers. The Hormones case concerned an EC ban on imports of beef from cows treated with hormones for growth-promotion purposes (oestradiol 17ß, progesterone and testosterone, trenbolone acetate (TBA), zeranol, and melengestrol acetate). The EC claimed the ban was necessary for food safety; the US and Canada claimed there was no evidence of harm to human health. The WTO Panel found that the EC measure violated art. 3 of the Agreement on the Application of Sanitary and Phytosanitary Measures: the EC measure was not based on these standards; it reflected a higher level of protection and was not justified by a risk assessment, as required by art. 3.3. When the EC was unable to implement the panel's findings by the 13 May 1999 deadline, the US and Canada sought the right to retaliate to the amount of US$202m per year and CDN$75m per year. The arbitrators found the appropriate level to be US$116m and CDN$11.3m per year, respectively. The United States raised tariffs against the EC on a list of goods including Roquefort cheese and *foie gras* among others, and Canada's list included cucumbers and gherkins, among others. The four episodes so far where action has been granted but not used are Bananas (Ecuador v. EC), Export Financing for Aircraft (Canada v. Brazil), Foreign Sales Corporations (EC v. US), and Export Credits for Aircraft (Brazil v. Canada).

enforcement mechanism is a powerful weapon for large countries, but a weak one for poor countries.

The policy space should be interpreted conservatively

Defining the policy space appropriate for attention within the WTO is a difficult task. There has been a tendency to expand the WTO's agenda to include all manner of international problems from intellectual property rights to protection for foreign investors. The international community has found that bringing formerly intractable international issues within the ambit of trade provides both a convenient negotiating forum and a ready mechanism for enforcement of agreements. If the only test of inclusion in the agenda is that a policy must affect trade flows, then the boundaries of WTO activity are very hard to define because almost all international problems can be linked to trade flows in some way. In this regard, policy-makers have liberally employed the prefix 'trade-related aspects of' to expand pragmatically the WTO's mandate into a growing number of issues.

However the growth of the WTO's policy space comes at a price. First, developing countries have limited capacity to analyse and negotiate over a large range of issues. Second, the experience of the Singapore Issues suggests that larger agendas burden the negotiations. Third, the expansion creates room for developed countries to use their superior bargaining power in trade negotiations to exploit developing countries over a larger range of issues. For instance, when the agenda was extended to competition policy, the issues relevant to the foreign business interests of developed countries became the main focus of negotiations while insufficient attention was given to key areas of concern for developing countries, such as rules against predation and the development of global anti-trust enforcement. Similarly the focus of intellectual property negotiations has been determined by the pharmaceutical industry in the industrialized world. Almost inevitably, the determination of these issues will reflect the consequences of the exercise of power.

For these reasons a 'principle of conservatism' needs to be introduced to guide the growth of the WTO's mandate. Further issues should only be included in the agenda of a Development Round if they score highly on three criteria: (1) the relevance of the issue to trade flows, (2) its development-friendliness, and (3) the existence of a rationale for collective action.

This third element reflects a general presumption in favor of national sovereignty. There is no reason to force nations to undertake certain actions unless their actions have effects on the trade of others which require collective action to resolve. There are areas in which a trade agreement is absolutely essential. These include an international rule of law (procedures) for dealing with trade disputes and/or agreements to prevent beggar-my-neighbor trade policies. There are areas in which international agreements would be beneficial in managing cross-border externalities or global public goods.[25] But modern trade agreements have been extended into areas which intrude into national sovereignty with no justification based on the need for collective action and without clearly identified and fairly distributed global benefits.[26] The presumption of consumer sovereignty is based on the premise that society should only interfere with individual choices when those choices have consequences for others, when there is a need for collective action, and the same is true in trade.

[25] For a discussion of the concept of global public goods, see Kaul *et al*. (2003). See also Stiglitz (1994, 1995).

[26] Trade agreements might also be useful as a mechanism for governments to overcome domestic political opposition to trade reform.