A World Trading System for the Twenty-First Century

Robert W. Staiger

Dartmouth

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  - hosted **eight rounds of multilateral negotiations** culminating in the Uruguay Round and the creation of the WTO in 1995
  - helped to **dismantle a web of restrictive trade protections** that had been erected in the 1920's and 30's
  - by the time the results of the Uruguay Round had been fully implemented, **average tariffs on industrial goods had been reduced to below 4%** and quantitative restrictions were largely eliminated

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  - **GATT's shallow approach to integration has been eclipsed by deeper forms of integration** with a focus on the trade effects of behind-the-border measures and increasingly on regulatory harmonization as an end in itself
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- Do we need a new world trading system to meet the challenges of the 21^{st} century?

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  - I show that the fundamental design features of GATT are well-equipped to serve this purpose in such a world
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  - and I argue that this harmony between purpose and design can help account for the success of the GATT/WTO in the 20^{th} century
- I then ask: Do any of these 21^{st} century challenges change the purpose of a trade agreement?
  - The answers can illuminate the nature of the challenges faced by the WTO and the world trading system

Main Findings

- I argue that the logic of GATT's design transcends many, though not all, of the current challenges faced by the WTO
    - The challenges posed by China's economic model, the rise of large emerging and developing economies in the world trading system more generally, digital trade, and accommodating efforts to address climate change can in principle all be addressed by exploiting the logic of GATT's design
    - The rise of offshoring and the push for regulatory harmonization as an end in itself may create the need for more fundamental changes to the GATT/WTO

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- With this advice I am not claiming that reforms to the world trading system are not needed, or that all is well at the WTO
- But I am claiming that the basic architecture of the GATT/WTO – and of the GATT, in particular – is well-suited to guide the design of the world trading system of the 21^{st} century

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- ⇒ Spoiler Alert
  - If the GATT/WTO was well-designed to handle the international externalities emanating from unilateral trade policy choices in the twentieth century,
  - and if the twenty-first century challenges faced by the WTO do not change the nature of these externalities,
  - then the WTO will be well-designed to handle the challenges of the twenty-first century

- In a broad set of environments the purpose of a trade agreement is the same: to eliminate terms-of-trade manipulation from tariffs and expand market access to efficient levels, and thereby to provide an escape from a terms-of-trade driven Prisoner's Dilemma

The World Trading System of the Twentieth Century: Purpose

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  - Holds under a wide array of government objectives that include political economy and distributional concerns, and leads to an expansion of market access (Bagwell and Staiger, 1999, 2002)
  - Holds in a many-country perfectly competitive world provided that tariffs conform to MFN (Bagwell and Staiger, 1999, 2002), and holds for general equilibrium or partial equilibrium environments (Bagwell and Staiger, 2001a)
  - Holds for trade in goods and trade in services when governments have access to additional domestic regulatory/tax instruments (Bagwell and Staiger, 2001b, Staiger and Sykes, 2011, 2021)
  - Holds in models of Cournot or monopolistic competition with homogeneous firms (Bagwell and Staiger, 2002 chapter 9, 2012a,b, 2015) and in models of monopolistic competition with heterogeneous firms (Bagwell and Lee, 2020, Campolmi, Fadinger and Forlati, 2020, and Costinot, Rodriguez-Clare and Werning, 2016, 2020)
  - Does require a complete set of trade tax instruments, but not a complete set of policy instruments more generally (Ossa, 2011, Bagwell and Staiger, 2012, 2015, 2016)
  - Does require the absence of international non-pecuniary externalities associated with policy choices

The World Trading System of the Twentieth Century: Design

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- And the economic logic of shallow integration is sound [Details]
    - According to the terms-of-trade theory, a tariff is the first-best instrument for manipulating the terms of trade
    - $\Rightarrow$ Nash tariffs are inefficiently high, but by an application of the targeting principle Nash non-tariff policies are efficient, conditional on Nash trade volume (Meade, 1955)

- In theory, a trade agreement could focus on lowering tariffs as a means of expanding market access ("conditions of competition") and trade volumes to efficient levels
    - And put in place various "market access preservation rules" that apply to non-tariff policies and prevent governments from using non-tariff policies to back-slide on their market access commitments

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- Under GATT's approach, countries negotiate tariff bindings to make market access commitments, and GATT Articles provide the accompanying market access preservation rules
  - For example, Petersmann's (1997, p. 136) observes that "...the function of most GATT rules (such as Articles I-III and XI) is to establish conditions of competition and to protect trading opportunities...".

The World Trading System of the Twentieth Century: Evidence

- There is evidence that GATT/WTO design features have helped governments achieve this purpose
  - Broda, Limao and Weinstein (2008), Bagwell and Staiger (2011), Bown and Crowley (2013), Ludema and Mayda (2013), Nicita, Olarreago and Silva (2014), Beshkar, Bond and Rho (2015), Beshkar and Bond (2017), Bagwell, Staiger and Yurukoglu (2020, 2021)

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    - Bagwell, Kyle and Robert W. Staiger. 2011. "What Do Trade Negotiators Negotiate About? Empirical Evidence from the World Trade Organization," *American Economic Review* 101(4): 1238-1273
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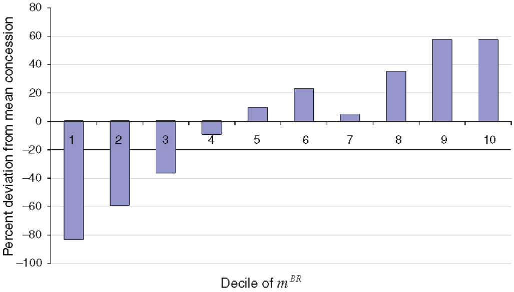
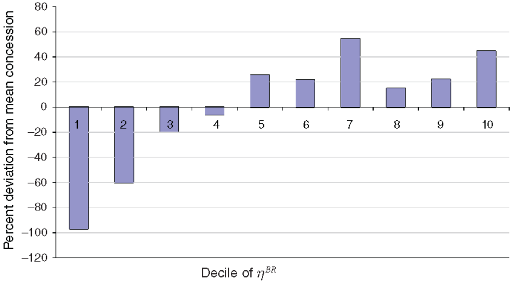
- I start with Bagwell and Staiger (2011), who focus on 16 countries that negotiated accession to the WTO after its creation in 1995 and ask whether their agreed tariff cuts reflect the removal of market power considerations from their unilateral tariff choices
  - In a linear model this tariff cut would be increasing in initial import volume m^{BR}, more generally it would be increasing in a measure of inverse trade elasticity η^{BR}

What Do Trade Negotiators Negotiate About?





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  - If so, then fundamental changes to the design of the world trading system may be needed
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- Below I consider
  - The rise of large emerging markets, led by China
  - Accommodating efforts to address climate change
  - Digital trade
  - The rise of offshoring and global value chains
  - The push for regulatory harmonization as an end in itself

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- I) Non-reciprocity and the rebalancing of market access commitments with China
  - China's 2001 accession to the WTO has challenged an approach to globalization that was designed fundamentally with market economies in mind
  - But the presence of a "China, Inc." does not change the purpose of a trade agreement
  - What it does change is the nature of the commitments that China must make to translate its tariff bindings into secure market access commitments
  - The non-violation clause provides a promising path to address the current impasse, with China not asked to adopt market reforms but instead given maximum autonomy to decide how best to guarantee its market access commitments (e.g., Poland's protocol of accession to GATT)

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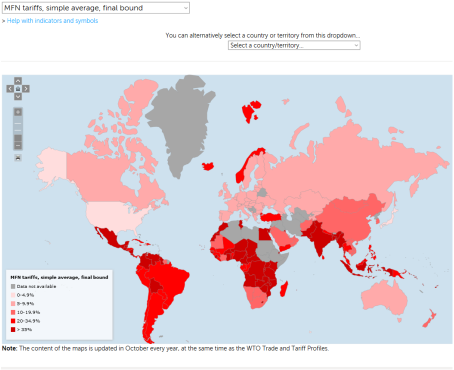
- II) Reconsideration by industrialized countries of the level of market access commitments they agreed to implement in 1995
  - Those industrialized countries that have experienced a significant increase in income inequality over the past several decades may now want to reconsider some of their existing tariff commitments
  - Article XXVIII renegotiations provide the liability-rule structure to achieve "efficient breach" of tariff commitments made in 1995

- III) Solving the "latecomers problem" (Bagwell and Staiger, 2014) and better integrating the large emerging market economies into the world trading system



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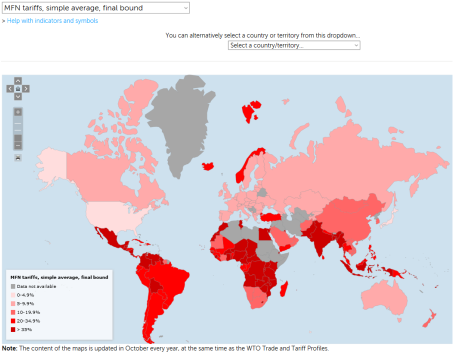

- Countries need the negotiating flexibility to transition toward the set of tariff commitments that the current WTO membership would have chosen to negotiate were they not constrained in their negotiations by their pre-existing tariff bindings
    - Article XXVIII renegotiations together with Article XXVIII bis negotiations provide countries with the flexibility to escape from their existing GATT/WTO tariff bindings in an orderly way when necessary, in order to then engage in reciprocal MFN tariff bargaining with all willing partners

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  - namely as a mechanism for addressing trade competitiveness impacts and "carbon leakage" concerns that arise when a country considers implementing more stringent carbon policies
- But there is a key difference: according to the terms-of-trade theory, these carbon border adjustments do *not* depend on the carbon content of the production of one's trading partners
  - These adjustments moderate the market access implication of a country's own increase in carbon taxes, and keep its market access at an efficient level as its carbon tax is raised to the efficient level
  - And while the market access implication of a country's carbon tax increase reflects the carbon content of its *own* production, it has nothing to do with carbon content in the country's trading partners

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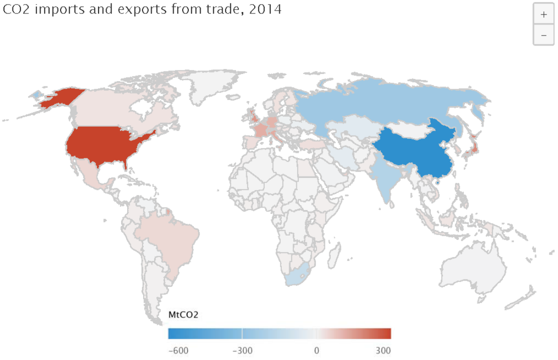

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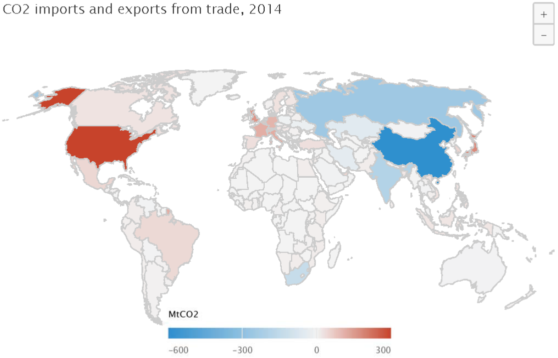

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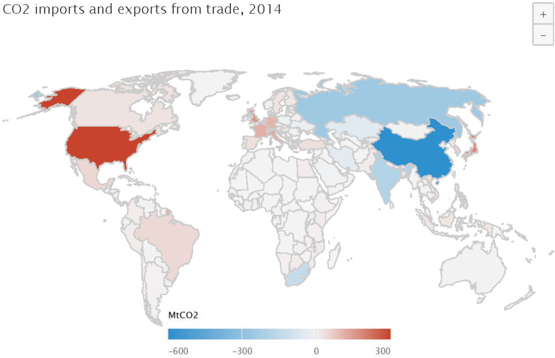

  - could help solve the latecomers problem
  - could help with enforcement of climate commitments, since indirectly the tariff cuts from large emerging markets would be contingent on the increase in carbon taxes promised by industrialized countries

Digital Trade

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- Where the non-pecuniary externalities associated with digital openness (related to issues such as privacy, national security and law enforcement) are purely local
    - The purpose of a trade agreement for both trade in goods and trade in services is unchanged by the advent of the digital world
    - This implies that the existing shallow-integration features of GATT can in principle be applied to digital policies impacting goods trade in such a world
    - And while GATS is a deep-integration agreement, a GATT-like shallow-integration approach to trade in services is possible along the lines suggested by Staiger and Sykes (2021), and could be applied to digital policies impacting services trade as well
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- Where the non-pecuniary externalities associated with digital openness cross international borders
  - The purpose of a trade agreement is more complex
  - But even in this case there may be an approach to integration for goods and services trade in a digital world that lies somewhere between the WTO's shallow integration approach and a fully deep approach

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- But trade in highly customized inputs may change the purpose of a trade agreement
  - if the nature of international price determination is altered, so that the tariff is no longer the first-best instrument for terms-of-trade manipulation (Antras and Staiger, 2012a, 2012b)

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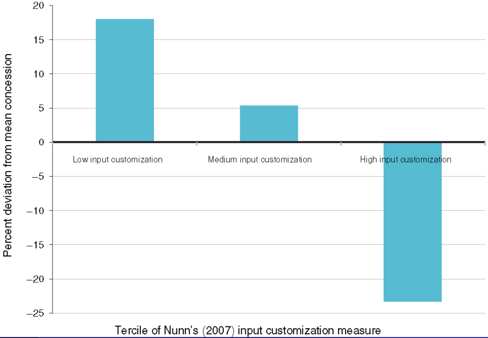
  - as long as international prices are still determined by the forces of supply and demand through market clearing conditions
- But trade in highly customized inputs may change the purpose of a trade agreement
  - if the nature of international price determination is altered, so that the tariff is no longer the first-best instrument for terms-of-trade manipulation (Antras and Staiger, 2012a, 2012b)
  - In that case, GATT/WTO architecture not well-suited for achieving efficient liberalization



The Rise of Offshoring and Global Value Chains

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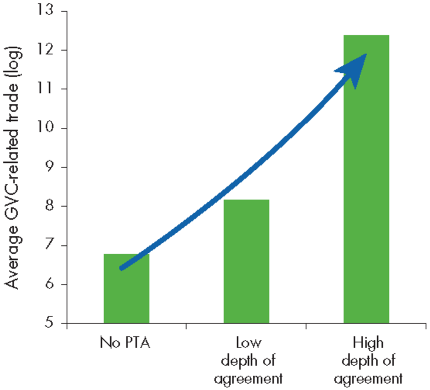

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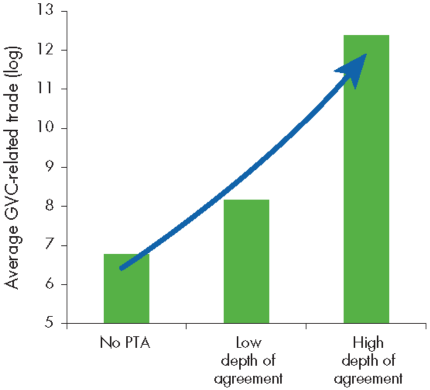

⇒ The rise of offshoring could necessitate fundamental changes to the design of the WTO, but thus far the evidence for this is only suggestive and indirect

The Push for Regulatory Harmonization

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- The terms-of-trade theory cannot take us very far in answering these questions
  - according to that theory, harmonizing regulations would be desirable only to the extent that it is needed to secure the property rights over negotiated market access, not as an end it itself

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  - Traditional market access/terms-of-trade manipulation concerns are put to the side
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$\Rightarrow$ Countries might negotiate selectively over standards where externality problems are present, and rely on some combination of national treatment and the non-violation clause combined with mutual recognition to achieve efficiency for standards that are not directly negotiated

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- **What is the WTO's role in preparing for the next pandemic?**
- The self-enforcement constraints (as in Bagwell and Staiger, 1990) faced by the WTO are likely to be extreme with the onset of a pandemic
  - This suggests that the WTO's role in preventing export restrictions during a pandemic will be limited
  - And the WTO may be most effective in helping countries cooperate over measures that could reduce the probability of pandemics in the first place, perhaps partnering with the WHO in this effort

A World Trading System for the Twenty-First Century

- I have argued that **the terms-of-trade theory of trade agreements** provides a compelling framework for understanding the success of GATT in the twentieth century
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  - Where the terms-of-trade theory applies the opposite may be closer to the truth, as with shallow-integration agreements countries might attain efficient policies without sacrificing national sovereignty
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⇒ The best advice for designing a world trading system for the 21^{st} century may not be "Move fast and break things," but rather ...


KEEP
CALM
AND
CARRY
ON

The World Trading System of the Twentieth Century: Design Details

- The terms-of-trade theory provides a simple framework within which to interpret two of the most basic features of GATT tariff negotiations

- I) Provides a reason why negotiators would view own-tariff cuts as "concessions" and seek foreign tariff cuts for their exporters

  - two-good two-country competitive general equilibrium trade model
  - gov objectives $W(p(\tau, \widetilde{p}^w), \widetilde{p}^w)$ and $W^*(p^*(\tau^*, \widetilde{p}^w), \widetilde{p}^w)$ satisfying $W_{\widetilde{p}^w} < 0 < W^*_{\widetilde{p}^w}$
  - Nash tariffs satisfy

$$W_p \overset{(+)}{\frac{dp}{d\tau}} + \overset{(-)}{W_{\widetilde{p}^w}} \overset{(-)}{\frac{\partial \widetilde{p}^w}{d\tau}} = 0; \quad W^*_{p^*} \overset{(-)}{\frac{dp^*}{d\tau^*}} + \overset{(+)}{W^*_{\widetilde{p}^w}} \overset{(+)}{\frac{\partial \widetilde{p}^w}{d\tau^*}} = 0$$

$\Rightarrow$ $W_p < 0 < W^*_{p^*}$ at Nash tariff choices; own-tariff cut a concession but matched with foreign tariff cut we can both gain

- Suggests the utility of a reciprocity rule that balances tariff cuts so as to leave $\widetilde{p}^w$ unchanged

- II) Provides basis for narrow focus on tariff negotiations
  - a domestic standard in each country, σ and σ^*, impacts that country's production possibilities, implying $\widetilde{p}^w = \widetilde{p}^w(\sigma, \sigma^*, \tau, \tau^*)$
  - gov objectives $W(\sigma, p(\tau, \widetilde{p}^w), \widetilde{p}^w)$ and $W^*(\sigma^*, p^*(\tau^*, \widetilde{p}^w), \widetilde{p}^w)$ satisfying $W_{\widetilde{p}^w} < 0 < W^*_{\widetilde{p}^w}$
- Conditions for efficient policy choices

$$\frac{[\tau W_p + W_{\widetilde{p}^w}]\frac{\partial \widetilde{p}^w}{\partial \tau^*}}{W_p \frac{dp}{d\tau} + W_{\widetilde{p}^w}\frac{\partial \widetilde{p}^w}{\partial \tau}} = \frac{W^*_{p^*}\frac{dp^*}{d\tau^*} + W^*_{\widetilde{p}^w}\frac{\partial \widetilde{p}^w}{\partial \tau^*}}{[\frac{1}{\tau^*}W^*_{p^*} + W^*_{\widetilde{p}^w}]\frac{\partial \widetilde{p}^w}{\partial \tau}}$$

$$W_\sigma + W_p \frac{dp}{d\tau}\frac{d\tau}{d\sigma}|_{d\widetilde{p}^w=0} = 0 \text{ and } W^*_{\sigma^*} + W^*_{p^*}\frac{dp^*}{d\tau^*}\frac{d\tau^*}{d\sigma^*}|_{d\widetilde{p}^w=0} = 0$$

  - Top condition describes efficient trade volumes; bottom conditions describe each country's efficient policies to deliver this trade volume
- Nash violates top condition $\Rightarrow$ tariffs too high/trade volumes too low
- Nash satisfies bottom conditions $\Rightarrow$ conditional on trade volumes, Nash policy choices efficient

$\Rightarrow$ Shallow integration

  - expand market access to efficient levels with tariff commitments
  - apply "market access preservation" rules to subsequent policy adjustments
  - and achieve policy efficiency

- Terms-of-trade theory also provides a basis for understanding nature of interdependence in a multilateral world

- Two-good three-country competitive general equilibrium trade model
  - Home exports y to $*1$ and $*2$ and imports x from $*1$ and $*2$

- Discriminatory home tariffs $\tau^1 \neq \tau^2$ imply that $p^{w1} \neq p^{w2}$ through $p = \tau^1 p^{w1} = \tau^2 p^{w2}$, hence home has distinct terms of trade with $*1$ and $*2$

- But MFN requires $\tau^1 = \tau^2 \equiv \tau$, hence $p^{w1} = p^{w2} \equiv \tilde{p}^w(\tau, \tau^{*1}, \tau^{*2})$
  - Gov objectives still $W(p, \widetilde{p}^w)$, $W^{*1}(p^{*1}, \widetilde{p}^w)$, $W^{*2}(p^{*2}, \widetilde{p}^w)$, externality still travels through $\widetilde{p}^w$

- But each country's welfare impacted by the tariff choices of the remaining *two* countries through $\tilde{p}^w(\tau, \tau^{*1}, \tau^{*2})$
  - In general a collection of bilateral MFN tariff negotiations represents a setting of bilateral bargaining with externalities

James Meade on Trade Agreements and the Terms of Trade

"[T]he restoration of greater freedom for international trade and factor movements can be made meaningful only by means of international agreements which cut rather deeply into domestic economic arrangements. One cannot hope to see the abandonment of protective devices except in the framework of all-round international agreement, since unilateral action is quite likely to cause the free-trade country to lose more from a deterioration in its terms of trade than it gains from the expansion of trade. But as soon as any attempt is made to limit protective devices, a whole host of domestic economic arrangements must be brought under examination. Tariffs and quantitative import restrictions are not the only means for protecting domestic industries. Subsidies, domestic taxes, domestic price and quantity controls, nationalization schemes – all can be used for similar purposes. Yet all of these instruments may be perfectly legitimate instruments of policy for the attainment of certain other perfectly legitimate objectives. ... If a more liberal international economy is to be established by international agreement, one must search for a working compromise between the need effectively to curb protective devices and the need to give national governments freedom to adopt effective domestic economic policies for the attainment of legitimate domestic objectives."

– The Theory of International Economic Policy, Volume Two: Trade and Welfare, by J. E. Meade. Oxford University Press, London: 1955, p 570.

Multilateral Trade Bargaining

- I next describe results from Bagwell, Staiger and Yurukoglu (2020a)
- Many GATT rounds utilized bilateral tariff bargaining, where requests for market access were matched by reciprocal offers, and with the results multilateralized according to MFN
  - According to the terms-of-trade theory, this approach to tariff bargaining can eliminate strategic bargaining behavior (Bagwell and Staiger, 2018a)
- The absence of strategic bargaining behavior is seen by GATT practitioners and legal scholars as a hallmark of the tariff bargaining that occurred in the early GATT rounds and as distinguishing GATT tariff bargaining from the tariff bargaining that preceded it
  - *...Their requests cannot be higher than their offers and negotiations start from this maximum position: if all requests are granted all the offers will be fulfilled. Similarly all other contracting parties are likely to make offers which match the requests they have made. As some of the requests are rejected, some of the offers are withdrawn. This procedure has been raised to a Gatt principle and is not laid down by any rule. It is a convention but one which creates a much better negotiating climate than the opposite trend which was a feature of the classical bilateral negotiations. Then, everyone put forward very low offers with the intention of increasing gradually if the bargaining proved profitable. A country never knew, however, when it had reached the maximum its partner was willing to concede. Curzon (1966, p. 74)*

Multilateral Trade Bargaining

- Curzon describes a tariff bargaining forum in which there is no point in making lowball initial offers, because governments are expecting non-strategic behavior from their bargaining partners and such offers would simply be taken at face value

- For GATT oldtimers
  - The initial offer made by a country ("sales") reduced tariffs to 0.808 of the existing tariff level while the final offer made reduced tariffs to 0.806 of the existing tariff level
  - The initial offer received by a country ("purchases") reduced tariffs to 0.817 of the existing tariff level while the final offer received reduced tariffs to 0.802 of the existing tariff level

		Sales			Purchases		
		Ad Val	**Specific**	**All**	**Ad Val**	**Specific**	**All**
		Country-Specific					
Initial request over existing tariff	Mean	0.543	0.577	0.554	0.512	0.582	0.539
	SD	0.235	0.306	0.260	0.257	0.321	0.286
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	17681	7971	25652	15621	9911	25532
Initial offer over existing tariff	Mean	0.804	0.817	0.808	0.796	0.845	0.817
	SD	0.195	0.233	0.208	0.213	0.218	0.216
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	8387	3577	11964	6578	5008	11586
Final agreed concession over existing tariff	Mean	0.797	0.827	0.806	0.773	0.831	0.802
	SD	0.200	0.235	0.212	0.211	0.240	0.228
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	5603	2394	7997	3384	3341	6725

Multilateral Trade Bargaining

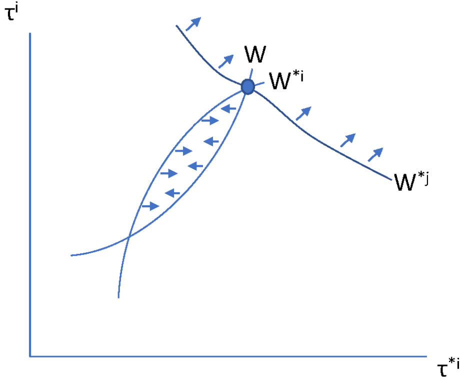
- *Several newcomers to GATT unaware of this new technique and starting with low offers found that in the course of negotiations they were unable to reach the level of requests they aimed for. Their initially low offers were taken as proof of their intentions and they either had to go home with a tariff higher than expected or had to increase their offers in the course of the negotiations.* Curzon (1966, p. 74)

- GATT newcomers
    - The initial offer made by a country ("sales") reduced tariffs to 0.855 of the existing tariff level while the final offer made reduced tariffs to 0.819 of the existing tariff level
    - The initial offer received by a country ("purchases") reduced tariffs to 0.833 of the existing tariff level while the final offer received reduced tariffs to 0.820 of the existing tariff level

		Sales			Purchases		
		Ad Val	**Specific**	**All**	**Ad Val**	**Specific**	**All**
		Country-Specific					
Initial request over existing tariff	Mean	0.471	0.611	0.544	0.571	0.617	0.585
	SD	0.294	0.327	0.319	0.223	0.290	0.246
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	4306	4696	9002	6366	2756	9122
Initial offer over existing tariff	Mean	0.827	0.870	0.855	0.829	0.840	0.833
	SD	0.229	0.203	0.213	0.179	0.225	0.197
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	1798	3445	5243	3607	2014	5621
Final agreed concession over existing tariff	Mean	0.725	0.846	0.819	0.807	0.849	0.820
	SD	0.179	0.241	0.234	0.183	0.232	0.201
	Min	0	0	0	0	0	0
	Max	1	1	1	1	1	1
	N	668	2271	2939	2887	1324	4211

Quantitative Analysis of Multiparty Tariff Negotiations

- And finally, I consider what we know about tariff bargaining in the absence of GATT rules
- I describe results from Bagwell, Staiger and Yurukoglu (2021) who ask: Could GATT tariff negotiations have performed better if MFN had been abandoned?
    - MFN can create a free rider problem in bilateral tariff bargaining settings (a positive 3^{rd}-party externality) that keeps countries from liberalizing all the way to the efficiency frontier
    - But in the absence of MFN and beginning from any point on the efficiency frontier, there is an incentive for each bilateral pair of countries to over-liberalize on a discriminatory basis and steal surplus from third countries (a negative 3^{rd}-party externality)



Quantitative Analysis of Multiparty Tariff Negotiations

- Which 3^{rd}-party externality is more damaging?

TABLE VII

ESTIMATED URUGUAY ROUND AND COUNTERFACTUAL OUTCOMES[a]

	Estimated Bargaining Parameters		All 0.5 Bargaining Parameters	
	MFN	No MFN	MFN	No MFN
	Δ% 1990	Δ% 1990	Δ% 1990	Δ% 1990
Δ Mean Tariff	−30.22%	−28.85%	−29.22%	−28.59%
Δ Trade Wgt'd Mean Tariff	−19.54%	−130.36%	−19.11%	−131.27%
Country Welfare				
US	0.01%	−0.13%	0.02%	0.11%
EU	0.02%	0.06%	0.03%	0.08%
Japan	0.10%	0.32%	0.06%	−0.24%
South Korea	0.17%	0.15%	0.32%	0.04%
Australia	0.06%	−1.71%	0.07%	0.18%
Canada	0.02%	−0.49%	0.02%	−0.59%
Africa NES	0.03%	−0.08%	0.02%	−0.09%
America NES	0.02%	−0.05%	0.02%	−0.04%
Asia NES	0.15%	−0.37%	0.17%	−0.33%
Europe NES	0.02%	−0.12%	0.02%	−0.16%
MENA NES	0.01%	−0.28%	0.00%	−0.49%
Mean	0.10%	−0.21%	0.11%	−0.19%
World Real Income	0.06%	−0.02%	0.06%	−0.07%

[a] Notes: Each column represents changes in the row relative to the pre-Uruguay tariff levels. Tariff averages are computed among nonagriculture sectors for the bargaining countries. The mean across countries is weighted by population.

ANNEX B

Draft Schedule LXV - Poland

1. Subject to paragraph 2 below, Poland shall, with effect from the date of this Protocol, undertake to increase the total value of its imports from the territories of contracting parties by not less than 7 per cent per annum.

2. On 1 January 1971 and thereafter on the date specified in paragraph 1 of Article XXVIII of the General Agreement Poland may, by negotiation and agreement with the CONTRACTING PARTIES, modify its commitments under paragraph 1 above. Should this negotiation not lead to agreement between Poland and the CONTRACTING PARTIES, Poland, shall, nevertheless, be free to modify this commitment. Contracting parties shall then be free to modify equivalent commitments.