PETROS C. MAVROIDIS

1 The Genesis of the GATT Summary

Our study on the negotiating record of the GATT[1] was meant to shed some light on the objectives that the framers of the GATT pursued through the establishment of the first genuine multilateral trade order in the 1940s: the quintessential element of the GATT was a tariff bargain supported by commitments on domestic instruments aimed at ensuring the value of tariff concessions entered by the negotiating partners. The whole enterprise was largely a trans-Atlantic negotiation between the UK (United Kingdom) and the U.S. (United States), where the former was requesting widespread MFN (most-favored nation) tariff cuts, and the latter, in return, the abolition of the UK imperial preferences.

1.1 The Years Before the Negotiation

The setup was a negotiation among like-minded countries (with very few exceptions), a ploy that was purposefully privileged in order to reduce negotiating costs: the idea was of course to extend the outcome to all nations, but it is of course one thing to negotiate a legal instrument of this scope, and a different thing to accede to it. The GATT was negotiated in three short (compared to today's trade negotiations) terms between 1946 and 1947, but the events that led to the negotiation predate this phase.

The outbreak of World War I in 1914 interrupted what had been a period of growing worldwide economic prosperity with moderate tariffs and expanding world trade supported by a well-functioning international monetary system (the gold standard). After the shock of World War I, the international trade and payments system recovered very slowly during the 1920s. Most countries only gradually phased out wartime controls on trade, while tariff levels remained higher than before the war. The UK did not return to the gold standard until 1925, and other countries waited even longer before restoring the convertibility of their

[1] Douglas A. Irwin, Petros C. Mavroidis, Alan O. Sykes, *The Genesis of the GATT*, Cambridge University Press: New York City, 2008.

currencies. Under the auspices of the League of Nations, the World Economic Conference of 1927 aimed to restore the world economy to its previous state of vigor. But the Conference started only an international discussion of matters such as tariff levels, MFN clauses, customs valuation, and the like.

The gradual restoration of the world economy was interrupted by a worldwide recession starting in 1929. This economic downturn was met by greater protectionism, which in turn further reduced world trade. Although monetary and financial factors were primarily responsible for allowing the recession to turn into the Great Depression of the early 1930s, the spread of trade restrictions aggravated the problem. The commercial policies of the 1930s became characterized as "beggar-thy-neighbor" policies because many countries sought to insulate their own economy from the economic downturn by raising trade barriers. Blocking imports proved to be a futile method of increasing domestic employment because one country's imports were another country's exports. The combined effect of this inward turn of policy was a collapse of international trade and a deepening of the slump in the world economy.

The U.S. bore some responsibility for this turn of events. What started out in 1929 as a legislative attempt to protect farmers from falling agricultural prices led to the enactment of higher import duties across the board in 1930. The Hawley-Smoot tariff of that year pushed already high protective tariffs much higher and triggered a similar response by other countries. According to the League of Nations (1933, 193),

> . . . the Hawley-Smoot tariff in the United States was the signal for an outburst of tariff-making activity in other countries, partly at least by way of reprisals.

Canada, Spain, Italy, and Switzerland took direct retaliatory trade actions against the U.S., while other countries also adopted higher tariffs in an attempt to insulate themselves from the spreading economic decline. The UK made a sharp break from its traditional free-trade policies by imposing emergency tariffs in 1931 and enacting a more general Import Duties bill in 1932. France and other countries that remained on the gold standard long after others had abandoned it for more reflationary policies imposed import quotas and exchange restrictions in an attempt to safeguard their balance of payments and stimulate domestic economic activity.

Many countries also turned to discriminatory trade arrangements in the early 1930s, for both economic and political reasons. At a conference in Ottawa in 1932, the UK and its dominions (principally Australia, Canada, New Zealand, and South Africa) agreed to give preferential tariff treatment for one another's goods. This scheme of imperial preferences involved both higher duties on non-British Empire goods and lower duties on Dominion goods and drew the ire of

excluded countries for discriminating against their trade. Meanwhile, under the guidance of Reichsbank President Hjalmar Schacht, Nazi Germany concluded a series of bilateral clearing arrangements with central European countries that effectively created a new trade bloc, orienting the trade of these countries toward Germany at the expense of others. In Asia, Japan created the Greater East Asia Co-Prosperity sphere to extend its political and economic influence throughout the region and siphon off trade for its own benefit.

The outcome of these protectionist and discriminatory trade policies was not just a contraction of world trade, but a severe breakdown in the multilateral trade and payments system that the world economy had previously enjoyed prior to World War I and had started to revive in the late 1920s. Official conferences and multilateral meetings, notably the World Economic Conference in 1933, offered pronouncements to resist protectionism, but failed to stem the spread of inward-looking anti-trade economic policies. The economic distress of the decade also had political consequences, undermining faith in democratic governments to manage their economies and hence abetting a turn to more authoritarian regimes in Germany and Italy.

1.2 The Negotiation

Following bilateral consultations between the UK and the U.S. that led to the drafting of the Suggested Charter (a document prepared by the U.S. delegation that reflected the bilateral negotiations with the UK), negotiations on the GATT were convened the last three months of 1946 and the first half of 1947 in three different places: London, Lake Success (New York), and Geneva. When the gavel went down in Geneva, a train consisting of hundreds of tariff concessions supported by commitments not to discriminate when recourse to domestic instruments was being made had left the station of protectionism.

The GATT was originally planned to be an agreement coming under the aegis of the ITO (International Trade Organization). Later on, when the ITO negotiation became increasingly difficult, it was decided that the GATT should enter into force only to be eventually superseded by the ITO, when the negotiation of the latter would eventually be completed. The ITO never saw the light of day; the GATT came into life with birth defects (since many of the terms, for example, were supposed to be further negotiated within the ITO) and lived on for close to 50 years: it became a *de facto* institution in order to fill the void left by the non-advent of the ITO. Contrary to the ambitious ITO project, the GATT is limited to regulating state behavior only, without touching upon trade impediments that are attributed to private behavior.

By accepting the GATT, trading nations signed up to a trade-liberalization model, whereby they accepted that they could, in principle, protect their domestic producer through tariffs only: QR are illegal, and domestic instruments

should not operate so as to afford protection. Trading nations further accepted that tariffs would be negotiated down in successive rounds of trade liberalization and that, in principle again, all tariff advantages would be extended to all their trading partners that have signed up to the GATT. Nevertheless, the ambit of nondiscrimination was tempered essentially, by accepting that imperial (and other, following the insistence of Chile to this effect) preferences would remain in place, at least during a transitional phase. This bargain is very much the outcome of the negotiation between the two transatlantic partners, the UK and the U.S. An implicit *quid pro quo* between them was the reduction of imperial preferences for an extension of MFN.

Nondiscrimination was further tempered by accepting an explicit provision on preferential trade agreements which opened the door to dozens of similar arrangements that proliferated slowly in the first post-World War II years, and at a much faster pace later on.

The basic bargain of the GATT was, as briefly mentioned supra, the tariff bargain, whereby trading nations promised each other reductions of their pre-GATT levels that they would consolidate and apply on an MFN-basis. The GATT, however, could not have contained just a provision on tariff consolidation and the MFN. For one thing, negotiating history reveals that negotiators were quite aware of (at least some of) the equivalence propositions: an import tariff can be decomposed to a domestic tax on consumption and a domestic-production subsidy that would produce comparable effects to that of the import tariff. This is why negotiators felt that a provision disciplining domestic instruments was a necessary addition that would operate as an anti-circumvention provision that would insure trading nations who had to "pay" through their own tariff concessions, for the tariff concessions obtained by their trading partners against the risk of seeing the value of concessions obtained, diluted through recourse to domestic instruments. A similar function explains of provisions such as the disciplining of state trading, and the introduction of NVCs (non-violation complaints) in the GATT text.

The GATT text, nevertheless, contains many provisions additional to those necessary to ensure that the tariff bargain would not be undermined: antidumping, balance of payments, safeguards, institutional provisions, etc. In our view, at least the following important explanatory variables have determined what should be added in the GATT next to the basic tariff-bargain:

(a) the influence that the failure to conclude the ITO has had on the negotiation of the GATT;
(b) the leading nation at the time (U.S.) was unwilling to undo some key trade-related legislation of its own;
(c) the different perceptions of the UK and the U.S. delegations on the role of the state in the handling of international trade relations;

(d) the emergence of some developing countries that became serious negotiating partners over the years.

Some remarkable people participated in the negotiation of the GATT from James Meade and Lionel Robbins (UK), to Cordell Hull and Will Clayton (U.S.) to Alexandre Kojève (France). The post-World War II era was indeed a time for statesmanship, as the participation of the leading economist of that era, John Maynard Keynes, in the Bretton Woods negotiation (that led to the advent of the World Bank and the International Monetary Fund) shows.

Finally, it bears mentioning (especially because of the law-and-economics nature of our project) that the drafting of the GATT was entrusted to a U.S. delegate trained in economics, John Leddy.

1.3 Property Rights of the GATT

The U.S. government entered the negotiations with considerable contractual experience, since it had negotiated similar trade deals before. The experience of the UK government in international trade issues was quite substantial as well. It was, thus, quite natural that the two transatlantic partners dominated the negotiations on the GATT/ITO, as they had also dominated the negotiations during the Bretton Woods conference a few years before. From a negotiating perspective, however, the UK was an ailing empire, while the U.S. emerged from World War II as the undisputed hegemonic power. The GATT would not have come into existence without the leadership of the UK and the U.S. However, there were many junctures in which the U.S. and the UK could have destroyed the plans for a multilateral commercial agreement.

In addition, other countries played an important role in shaping the GATT. It is interesting to note that, despite its overwhelming economic strength in comparison to other countries, the U.S. could not dominate or dictate the outcome to other countries. Rather, the U.S. often accommodated the demands for exceptions or weaker language at various points in the negotiations to ensure the continued participation of other countries. This is probably the influence of Cordell Hull, who wanted a trade deal and believed that it was the duty of the U.S. as a leader to enforce the deal, even if it meant concessions on its behalf. Chile requested and obtained the extension of exceptions to MFN. A host of developing countries should be credited with the inclusion of provisions on infant-industry protection, and so on.

The input of the other (than the UK and the U.S.) players should not be overestimated: the bulk of the negotiation was entrusted to the two transatlantic partners; UK and U.S. delegates participated in all committees, groups, etc. established. As we unveil the negotiating history of the GATT, it becomes apparent that this observation holds true throughout all stages of the negotiations.

Although participation in the various committees is no perfect proxy to measure the influence that participating delegations have had on the final text, few would argue with the point that participation is a necessary (albeit, not sufficient) condition for influencing the eventual outcome. It bears repetition that UK and U.S. delegates are the only national delegates that participated in all committees, groups, etc. Their point of view on each and every provision that made it to the final GATT text has been consistently discussed (and often, retained). With one exception, they were simultaneously present in all committees during the London Conference, where the "heart and soul" of the GATT was constructed.

The transatlantic partners should be credited not only with the basic architecture of the GATT, but also with the shaping of technical provisions aimed to support the whole edifice. A good illustration is offered by the provisions regarding customs valuation, fees, and formalities. It is the UK and U.S. administrations that possessed the more sophisticated customs administration that were routinely dealing with thousands of customs-clearing transactions: it is, consequently, only natural that it is the UK and U.S. delegates that shaped Arts. II, V, VII, and VIII of the GATT.

A comparison, of the provisions retained, points to the same conclusion: most provisions agreed to in the London Conference are directly inspired from the corresponding provisions in the Suggested Charter, which had been negotiated only between the UK and the U.S. And the London text was only partially and marginally modified in the subsequent Lake Success and Geneva negotiations.

There is more evidence pointing to this conclusion: Johnson (1968) explains that the principal-supplier rule, followed in the original negotiation, effectively barred developing countries from effective participation, since no developing country was a principal supplier in any commodity. MFN somewhat diminished the effects of nonparticipation in the tariff negotiation, but is not a perfect substitute. In his words (p. 368):

> . . . the real trouble with the GATT is not the institution of bargaining for tariff reductions, but the techniques for bargaining. . . .

The negotiating rules changed only in the fourth round (Geneva), as reported in Kock (1969). Wilkinson and Scott (2008, 484ff.) point out that many developing countries were more active during the ITO negotiations, since they thought that the GATT would effectively come under the aegis of the ITO. Scarcity of negotiating resources among them meant the need to prioritize their efforts, and in their view, the ITO was priority. The failure of the ITO means, ipso facto, that their negotiating efforts were in vain. It also meant that their influence on the drafting of the GATT remained marginal.

Finally, one should not turn a blind eye to the "nucleus" approach advocated by Canada and accepted by all participants: the GATT was designed to become

the vehicle for trade liberalization around the world; in Canada's view nevertheless, the negotiation would suffer had it been open from day one to all trading nations. Rather, the whole endeavor would be greatly facilitated if the negotiation were to take place across like-minded countries. This is what largely happened. The USSR (Union of Soviet Socialist Republics) was invited but declined the invitation; it is the nationalist China that participated in the negotiation, and Czechoslovakia entered the negotiation as a Western country (finished it as "socialist," but did not abandon the GATT). The only concession to the "nucleus" approach was the acceptance of developing countries in the negotiation. But at that point in time (1946), Australia would qualify as a developing country, as would many European countries devastated by World War II.

1.4 What Did The GATT Framers Have in Mind?

Economic theory has advanced two theories to rationalize why trade agreements occur: the commitment theory, and the terms-of-trade theory. The former focuses on the relationship between government and its private sector: a government will choose its trade policy and will commit it in an international agreement signed to this effect; the private sector will act accordingly. The gain for the government is that investment decisions are forestalled; it will lose, however, contributions by the various lobbies. The latter differs in that it traces the rationale for trade agreements not in domestic distortions but in international externalities (and in the manner in which they "travel"). The study of the negotiating record does not make a conclusive case for either. Indeed, this is one of the reasons why we decided to undertake a separate study on the economic rationales for the GATT.

It definitely, though, rejects the commitment theory: as mentioned, domestic instruments are not disciplined by the GATT other than GATT through the principle of nondiscrimination. The GATT is a negative integration-contract, where domestic policies will be defined unilaterally and must only respect the obligation not to discriminate across domestic and foreign goods participating in the same product market.

Some elements of the GATT, like the principal-supplier rule, lend some support to proponents of the terms-of-trade theory. At the same time, the extension of MFN to all (and future) participants underscores the idea that Cordell Hull's initial aspiration to conceive the establishment of a world-trade order as a contribution to world peace ultimately carried the day.

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GENE M. GROSSMAN AND HENRIK HORN

2 Why the WTO? An Introduction to the Economics of Trade Agreements

2.1 Introduction

This study is part of The American Law Institute (ALI) project *Legal and Economic Principles of World Trade Law*. The project aims to analyze the central instrument in the *World Trade Organization* (WTO) Agreement for the regulation of trade in goods – *The General Agreement on Tariffs and Trade* (GATT). The present study is one of two background studies for this project.[1] The first study, *The Genesis of the GATT*, appraises the rationale for the creation of the GATT, and tracks its development from a historical and legal perspective. This second study provides an overview of the economics of trade agreements.

A distinguishing feature of this ALI project is the desire to base the analysis of the GATT firmly in both economics and law. The necessity of legal analysis needs no justification. But why also base the study in economics? Art. 31.1 of the *Vienna Convention of the Laws of Treaties* states that an international agreement should be interpreted "in the light of its object and purpose." There are fundamental reasons why the interpretation of the GATT therefore cannot be adequately addressed without economic analysis. First, we will discuss below the possible purposes of the agreement in much greater detail, but for now let us just quote the Preamble to the GATT, to show that the *objectives* of the GATT are expressed in inherently economic terms:

> ...Recognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods, ...

[1] There is a second leg to the ALI project, in which economists and lawyers jointly analyze the emerging case law from the WTO dispute-settlement mechanism.

This study builds on joint work, and many discussions, with Kyle Bagwell and Robert W. Staiger. We have also greatly benefited from many exchanges with Wilfred J. Ethier and Donald Regan. Don also provided very helpful comments on an earlier draft, as did Evan Wallach.

Furthermore, these objectives are linked to the policies that the GATT regulates through the *operation of markets*. It is clearly necessary to understand these mechanisms in order to appropriately interpret the agreement, and this in turn requires economic analysis. Hence, an appreciation of both the objectives of the GATT and the mechanisms by which its stipulations further those objectives requires that the analysis is based in economics. An analysis of the GATT that relied solely on a traditional legal perspective would be inadequate.

The need for a joint economic and legal analysis of the GATT implies that the analysis must be undertaken jointly by economists and lawyers. Such collaboration requires an understanding among economists of the law and of legal analysis, and a corresponding understanding among lawyers of fundamental economic concepts and reasoning. The purpose of this second background study is to lay out to readers with little or no training in economics (but with sufficient patience and intellectual curiosity), the perspective that most trade economists bring to the study of trade agreements, in general, and the GATT in particular. The aim is not to provide a comprehensive survey of the literature on trade agreements, nor to evaluate the relative importance of the contributions to the literature, but rather to sketch some of the basic underlying principles.[2] To this end, the study focuses on the main analytical approach to the study of trade agreements, largely putting other approaches aside, irrespective of their intellectual merits.

To illustrate the importance of understanding the purpose of the agreement when interpreting it, consider the role of a safeguard provision that allows a country to temporarily exceed its tariff binding for an industry, provided that the industry has suffered "serious injury" as a consequence of increased imports. How should the word "serious" be interpreted in this context? The answer depends on what the GATT Member governments are trying to achieve. If, with the creation of the GATT, governments hoped to achieve more liberal trade but needed assurances that they could "escape" from negotiated commitments if unanticipated events later occurred, then economic arguments would suggest caution in interpreting the serious-injury standard too stringently, lest governments, fearing the "straightjacket" that GATT commitments might then imply, would be hesitant to accept tariff commitments in the first place. If, instead, governments hoped to "tie their hands" with GATT commitments, so that when later faced with protectionist pressures they could resist offering palliatives, then a "straightjacket" would be exactly what the governments would have hoped

[2] Surveys of various strands of the literature can be found in, e.g., Bagwell and Staiger (2002), Ethier (2011), Hoekman and Kostecki (2009), Magee (1994), Nelson (1988), Schropp (2009), Rodrik (1995), Staiger (1995), and WTO (2008).