

The Economics of the World Trading System

by Kyle Bagwell and Robert W. Staiger

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Before the late 1990s, a trade economist who wished to delve into research on the theory behind the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) faced significant barriers to entry. First, as research into the GATT/WTO framework has historically been the domain of legal scholars and political scientists, an audience of these researchers was skeptical of any economic “insights.” For example, the prevailing thought was that application of such truly academic economic concepts as the “terms of trade effect” to motivate the existence of the GATT/WTO must clearly be misguided; government policymakers surely never refer to such esoteric themes in the midst of real world trade policy negotiations! Second, given that anything that most economists knew about the GATT/WTO would originate from such scholars in other fields, the prevailing opinion even amongst economists was that these institutions derived largely from political considerations and thus lacked any economic basis or foundation.

In their joint *economic* research agenda spanning the last fifteen or so years, Kyle Bagwell and Robert Staiger have gone to extraordinary lengths to improve the dialogue between economists, legal scholars, political scientists and even policy makers that share space in the research area defined as the “economic rules of the world trading system.” The results of much of their economic research on the GATT/WTO are compiled into a new book. Furthermore, while their research and approach is distinctly economic, the text provides something that scholars in each of these fields will appreciate. Nevertheless, the constituency that will benefit the most from this text is likely to be readers of the *JIE* -

economists with an interest in international trade policy who want to know what economics has to say about the GATT/WTO.

It is well known that one critical value-added of Bagwell and Staiger to this area of research is their approach: 1) they take the writings of the GATT/WTO agreements and legal scholars seriously and 2) they use rigorous economic theory from the frontiers of international trade, political economy, industrial organization and game theory in their models. Their intention in this book is to interpret the economics behind the formation of international trade agreements and, in particular, of the GATT/WTO institutional structure. The result is that they show that the GATT/WTO's core underlying principles are efficiency-enhancing, illustrating that the GATT/WTO does have an economic foundation!

As scholars of the GATT/WTO are now forced to confront economic insights and research seriously, the Bagwell and Staiger research may have already eliminated one set of entry barriers facing economists seeking to engage in this field. Nevertheless, the papers published by the authors in academic journals in recent years may have inadvertently generated some new entry barriers. To an economist unfamiliar with the landscape, a first glance at a typical Bagwell and Staiger paper in the theoretical literature may be startling. Especially in their research published over the last five years, Bagwell and Staiger use economics to carefully interpret relevant texts related to GATT/WTO: agreements, interpretations, language and relevant work by legal scholars. But this implies that they have looked at and even thought about such texts! Their rigor at doing so implicitly mandates that other economic researchers take the GATT/WTO as seriously

as they. Therefore, at first blush, initiating an economic research agenda relating to the GATT/WTO could appear to be a particularly daunting task, given the substantial start-up costs to an economist becoming fluent in “GATT/WTO-speak” that are separate from the costs of becoming competent (or even interested!) in research in international trade policy. In this book, the authors have made it a priority to work diligently to ensure that the interested economics audience can quickly become proficient enough in the GATT/WTO-speak necessary to start a research agenda in the area. Importantly, the book assumes little prior familiarity with the GATT, WTO or legal texts. Thus I foresee one important benefit of this book to the field of economics as reducing entry costs that face interested researchers that are making a decision regarding whether to delve deeper into the area.

Bagwell and Staiger undertake this and related challenges subtly throughout the text, but in a number of important ways that will be beneficial to both new and more experienced researchers in the field. First, they pointedly reference the writings by the pre-eminent legal scholars on these topics [e.g., Jackson 1997, Hudec 1990, Dam 1970, Petersmann 1997] that are best-suited for economists to use to generate a relatively quick but thorough competence with the GATT/WTO. This element of their book should not be understated. There are tomes of legal writing in this area, and the vast majority of such texts is, of course, frustratingly difficult for an economist to understand. Without this guide for where to start, many economists may struggle blindly on their own and come to the incorrect conclusion that the cost to understanding the consensus view amongst legal scholars regarding an important GATT/WTO issue is not worth the effort. This book now

provides economists that are new to the field of multilateral trade agreements with a source that describes how to get started in the economics and legal literature in order to most quickly get up to speed. Furthermore, with respect to the specifics found in the book, there is also a concise historical introduction to the GATT and its evolution into the WTO institution provided in chapter 3.

Second, the more experienced researcher in the field will appreciate that Bagwell and Staiger typically introduce a new topic in the book by providing their own economic interpretation of the GATT/WTO-relevant rules or interpretations, while carefully also supplying a quotation or reference to the relevant writings of legal scholars. As a scientific matter, this approach allows the more adventuresome reader to potentially ignore or re-phrase the Bagwell and Staiger economic interpretation in order to come up with a different modeling assumption. I interpret the authors' style in this regard as empowering other researchers to become proficient in GATT/WTO-speak without forcing everyone to have a Bagwell and Staiger accent or dialect.

Furthermore, with the added space of a book that the confinement that a journal article may not allow, Bagwell and Staiger are able to provide a somewhat more in-depth explanation of some of their linkages between economics and GATT/WTO rules and interpretations. Stylistically, this is well done, as many of the references are put into footnotes so that a reader that is less interested in the details of the linkages will not need to be caught up by some of the minutiae.

While I have thus far highlighted the benefits of Bagwell and Staiger interpreting and integrating the work of legal scholars in the field, these statements should not be

misinterpreted as implying that such work has been done at the expense of a thorough exposure to the economic models that are at work in the literature. The book is not short on economic rigor or models. It is well-structured: chapter 2 first develops their workhorse, general equilibrium, politically-augmented model of trade between two large countries of Bagwell and Staiger (1999). The book then uses their fairly general model to focus sequentially on their arguments regarding the economic, efficiency-enhancing properties of the core GATT/WTO principles: the *reciprocity* principle (chapter 4) and the *most-favored-nation (MFN)* principle of nondiscrimination (chapter 5). These two chapters in particular provide various extensions and clarifications regarding how different aspects of their evolving research may be combined to shed light on the value of these principles to international trade agreements.

Unlike many books of this kind, this text is also much more than a simple repackaging or collection of the authors' previously published papers. Here I will comment on two specific aspects of this book that make it a very important complement to existing research on the topic. The first is that the authors use the book to "reinterpret" some of their own earlier published results. The best example of this furthers the dialogue between economists and non-economist GATT/WTO scholars regarding an interpretation of the Bagwell and Staiger (1999) results concerning the *terms-of-trade-driven Prisoner's Dilemma*. Instead of stubbornly thumbing their noses at the concern of the non-economist audience, both early in the book (on pages 28-29), and then again in the stand alone chapter 11, they treat the response of this audience seriously and convincingly argue how their results regarding the "terms of trade" (the language of economists) can be re-

interpreted as results equivalent to a change in conditions of “market access” (the language of legal scholars and policymakers).

A second important example of the value-added of this book is that it contains important discussions as to how some “competing” or “complementary” theories fit within the Bagwell and Staiger models. It would have obviously been impossible to do this in the journal version of many of the academic papers, because the competing or complementary theories may not yet have been fully developed. Particular examples include the authors’ insights on pages 30-31 and 94 of how Ethier’s (2000) work on political externalities and related issues can be interpreted within their context. I would have enjoyed more of such discussions, but admittedly the authors have a limited number of competing theories with which to work given the infancy of the field. This may be an easier task in a second edition when I would expect they have more material with which to work.

The remaining chapters provide extensions to their workhorse model and discussions of alternative models that they and other researchers have taken to provide theories for various elements of international trade agreements. For example, chapter 6 discusses the models that focus on the limits to cooperation in a self-enforcing trade agreement like the GATT/WTO, when government-to-government interaction is treated as a repeated, tariff-setting game between countries. They thus highlight one motive for countries to include an “escape clause” in trade agreements – so as to allow governments a moderate deviation from liberal trade in periods of import surges, thus preventing a trade war from escalating and the entire agreement from falling apart. Chapter 7

integrates the literature on preferential trade agreements (PTAs) into a discussion of the GATT/WTO, highlighting the economic implications of one of the most important practical exceptions to the nondiscrimination principle that the GATT/WTO allows.

Chapter 8 takes the workhorse model and integrates externalities, allowing for a discussion as to how their modeling approach can address the question of including labor and environmental standards into the GATT/WTO framework. Bagwell and Staiger further extend the model in chapter 9 to address the issue of directly including competition policy in the GATT/WTO. Finally, chapter 10 provides a discussion for how a combination of their politically-augmented model and insights from the strategic trade policy literature of Brander and Spencer (1985) might be reinterpreted to shed light on the prevalence of agricultural export subsidies worldwide and GATT/WTO rules limiting such subsidies.

No book is perfect, so what is missing? The most glaring omission is that, with exception to chapter 11, there is very little discussion of related empirical work. Most of this omission is not the authors' fault: like many areas of research in the field of international trade, research by theorists has far outpaced empirical assessments of the theory. Nevertheless, the empiricist side of me would have enjoyed discussions on the authors' thoughts regarding relatively clean ways to "test" some of these theories, or perhaps what empirical insights would be most useful for the theorists seeking either to make further refinements to the theory or to choose between potentially competing theories. Finally, while this book is not designed to be a *Handbook*, graduate students

especially would likely have enjoyed a more substantive discussion of remaining gaps in the literature that future research could fill.

This book will also not appeal to everyone. Trade theorists familiar with the Bagwell and Staiger body of research may be a little disappointed if they expected a text that would provide new theoretical advances, as that is clearly not the authors' intention in writing this book. Furthermore, serious theorists working in the area will likely discover that this book does not substitute for a thorough reading of the academic journal presentations of the Bagwell and Staiger models. Such readers will find it useful to use this book as a guide, but they will then want to go back to the original paper for the details of the models and the proofs which, in the book, are frequently provided in an appendix.

Bagwell and Staiger have written a text that is a valuable addition to the field, and there is nothing else out there like it. The new book is likely to become the first source for any scholar interested in the economics of the multilateral, GATT/WTO trading system.

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