

EUROPEAN BUSINESS SCHOOL  
International University Schloss Reichartshausen

**Course Essay**

*Law and Economics*  
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***The World Trade Organization***

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## 1. Why? - Need for a World Trade Organization

As Ricardo shows in his theory of the comparative advantage, free trade generates - in most of the cases- welfare gains for every country participating in it. Through trade the efficiency of the world economy is raised. So, to ensure that every country is able to reach its productive optimum, in theory the free flow of goods, services, workforce and capital has to be ensured. The World Bank and the World Monetary Fund are the institutions responsible for the latter, so the free flow of capital will not be dealt with in this essay. The free flow of workforce signifies an alternative to the free flow of goods. In economic theory, it makes no difference whether the production factors (a great part of which is labor) or the end product is transferred across nations. It becomes obvious, that in the real world it should be much easier and more efficient to substitute factor movement by goods movement. Therefore efforts should be directed towards the liberalization of goods market rather than labor (and/or resource) markets. In history the benefits of free trade were known early and many nations engaged in bilateral treaties, ensuring their possibility of exporting those goods in whose production they possessed a comparative advantage.

The other advantage of trade amongst nations is that two nations who are economically interwoven are unlikely to settle disputes through military intervention. Attacking a trade partner would also threaten the economy of the attacking nation; therefore trade secures peace amongst those nations engaged in it. This may not be the main motivation for trade treaties, but could be seen as a welcome side effect.

The greatest threats to the flow of goods are tariffs, blockades and quotas. From an economic point of view all three of them can be treated similarly as trade barriers. Quotas and tariffs hinder the international market to exchange goods for the (from a welfare perspective) optimum price and in the optimum quantity. Blockades, which can be seen as the most extreme quota -i.e. zero- destroy the forces of the market and in the worst case hinder the consumers of a country from having access to certain (imported) goods at all. To ensure the (economically) optimal use of the world resources all trade barriers should be abolished.

The problem of a free market evolves for those who are not participating in it. The economy of the outside country has to watch the trading nations evolving (from a welfare point of view) much faster than its own. The outside economy lags behind, which will sooner or later lead to a problem also for the trading nations, to mention social unrest, war, etc.. So, to ensure a sustainable development of the world economy it is important that no country is discriminated, when it comes to free trade.

The first step out of a chaotic web of hundreds of bilateral treaties was the *General Agreement on Tariffs and Trade*, or *GATT*. In 1944 while the 44 participating nations of the Breton Woods conference could agree on creating the two institutions World Monetary Fund and World Bank, they were discordant when it came to the creation of a worldwide trade institution. Instead, 23 of them agreed on the GATT, which became effective in 1948. The two pillars mentioned before, the reduction of trade barriers and the non discrimination amongst nations when it comes to trade modalities, were already set out in this contract. From 1948 until 1994 the GATT contained the rules of international trade. In eight rounds of negotiations, where each participating country negotiated with a number of other countries over several years, it was modified and expanded and existing trade barriers were abolished step by step. The number of participating nations grew to 123 until 1994 (World Trade Organization, 2008a).

The problem with the GATT was that it was de-jure not an institution with a legal body but only a multilateral contractual agreement. Though it was de-facto administered through a secretary in Geneva, which was commonly called “the GATT”, the need for a full-fledged institution with better enforcement possibilities grew stronger and stronger. In the last negotiation round of the GATT, the so called Uruguay-Round (as it started in Uruguay), which took place from 1986 until 1994, much effort was put in the creation of a legal international institution to administer the GATT (and other contracts) and serve for dispute settlement purposes. Finally on April 15<sup>th</sup> 1994 the World Trade Organization was founded in Marrakesh and became effective on January 1<sup>st</sup> 1995 through the signing of the *Agreement establishing the World Trade Organization* (hereinafter referred to as WTO-Agreement).

## 2. How? - The Framework of the WTO

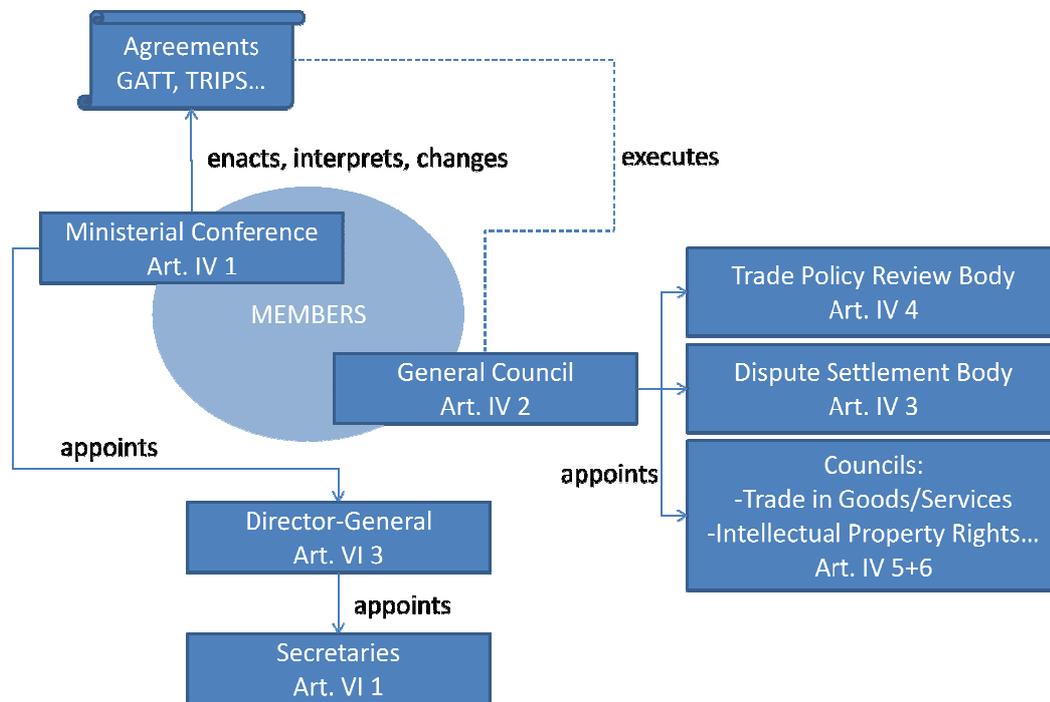
The WTO is an international institution with a legal personality (Art. VIII 1 WTO-Agreement) and 153 -theoretically- equal members. The GATT was not abolished by the creation of the WTO, but is still the main comprehensive body of legislation for international trade. Each member of the WTO is automatically a contractual party of the GATT (Art. XI 1 WTO-Agreement). The WTO serves as a forum for negotiation and administers the underlying codes, like the GATT or the newer *Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)*. Another main objective of the WTO is the settlement of disputes arising from the agreements. The WTO has a staff of about 600 permanent employees and has its Headquarters in Geneva (World Trade Organization, 2008b). It is structured as follows:

The main body of the WTO is the **Ministerial Conference**, which assembles “at least once every two years” (Art. IV 1 WTO-Agreement). Each member state sends one delegate (usually the Economy or Trade Minister) with one vote to those rounds of negotiations. The Ministerial Conference agrees on new resolutions, interpretation of existing agreements and establishes committees for specific topics. It also appoints the Director-General.

The **General Council** is comprised of delegates of all member states and executes the agreements of the Ministerial Conference. Between the meetings of the Ministerial conference “its functions shall be conducted by the General Council” (Art. IV 2 WTO-Agreement). It appoints the necessary organs to administer those duties. The most important organs are the **Dispute Settlement Bodies** and the **Trade Policy Review Body**. The Trade Policy Review Body ensures that every member country acts according to the rules set out in the agreements through surveillance (Art. IV 4 WTO-Agreement). The function of the Dispute Settlement Body will be discussed later, when it comes to the question of enforcement (see 3.). The General council appoints several sub councils, who are responsible for the surveillance of the different agreements, like the Council for Trade in Goods or Trade in Services or the Council for Intellectual Property Rights.

The **Director-General** appoints the Secretaries and the staff of the WTO and sets out their powers and responsibilities. Since 2005 the Director-General is Pascal Lamy (a left-wing French politician). The Director-General is independent from any national

government and his responsibilities should be “exclusively international in character” (Art. VI 4 WTO-Agreement).



*Illustration 1: The Structure of the WTO*

### 3. The Decision-Making Process and Enforcement

In the Ministerial Conference and the General Council, each member state has the same voting power (Art. IX 1 WTO-Agreement). Opposed to the EU, for example, the voting power is independent from the economic power or monetary contribution of the member state. On the first glance this appears to be the most democratic process imaginable, but one has to keep several aspects in mind. Usually the voting is done by simple show of hands, if a strong economic power is in favor of a specific aspect this puts pressure on smaller economies who do not want to risk their relations to this country (Steinberg, 2002). Also, many of the decisions of the Ministerial Conference are contractual by their legal nature (modifications of GATT, amendments and new agreements etc.), which means they are only binding for those countries who agreed to them. So, the primary goal has to be to find a consensus among the member states, weighted voting would make no sense here. If a consensus cannot be reached, generally a majority vote is often sufficient to come to a decision.

If the decision resembles a contractual agreement (as mentioned above, e.g. an amendment to GATT) a 2/3 majority is necessary. Possible opposing members are then forced to yield to the majority, threatened with the exclusion from the WTO. To avoid rigidity and react according to specific economic conditions of a country, some countries may be excluded from the responsibilities of a decision. Those so called *waivers* need a 3/4 majority and are subject to constant surveillance.

The possibility to enforcement rules set out by the ministerial conference is somewhat limited. The WTO has no means to punish a country directly. The only mechanism is the ability to grant a country the possibility of retaliation if another country violates the agreements of the WTO. Each member has the right to bring another member to trial if disputes arise. This dispute settlement process functions as follows:

First, the parties involved are asked to settle their dispute through bilateral negotiations. A Dispute Settlement Body appointed by the General Council acts as consultant and mediator. If this is unsuccessful a panel is installed, this panel comprises of three law and commerce experts from countries not involved in the conflict. This panel comes to a decision which is subject to appeal. If this happens, an appellation panel (again comprised of impartial law and commerce experts) comes to a final and jurisdictional binding decision, which can only be annulated by a 2/3 majority vote of the Dispute Settlement Body. The case must be closed in not more than 18 month, which shows the focus on practical and fast jurisdiction. If the accused nation is found guilty of violating an WTO agreement, the plaintiff is given the right to retaliate by imposing tariffs and other means on the other country, without being accused of violating the WTO agreements itself.

#### **4. Concluding Remarks**

The economic calculus, mostly done by the WTO itself, estimates a growth in world profits of about 200 Billion USD, which reflects an increase in the world real income of about 1%, if all the agreements of the Uruguay Round are fully implemented (Krugman & Obstfeld, 2006, P. 302). The costs of the liberalization of global markets will be burdened upon few well organized groups, like European Farmers

who today profit from protective tariffs, or the entrepreneurs and workers in the textile industry of industrialized nations, who face a comparative disadvantage. The gains on the other hands will mostly be on the side of the vast and unorganized group of the consumers due to lower prices of and better access to traded goods (Krugman & Obstfeld, 2006, P. 303). The step from the GATT towards a fully-fledged institution with a legal personality was necessary and in history prevented due to the opposition of the United States of America (Van den Bossche, 2008, P. 81). After all, the GATT de-facto operated as a “World Trade Institution” for over 40 years.

The WTO as an institution also resembles an incorporation of all the negative aspects related to globalization in general. So all the criticism, like qualifying environmental protective measures as trade barriers or destruction of local production can also be brought forward against the WTO. The weak standing against subsidies, which also can act as effective as trade barriers, could be a point of action for criticism of the agreements the WTO is founded upon. The criticism of the WTO as an organization on the other hand could be, that it creates a new forum for lobbyism, which endangers the objectivity of decisions taken (Qureshi & Ziegler, 2007, P. 290). Also, the need for consensus in the decision making process leads to time consuming and often failing negotiations (e.g. Seattle 1999, Cancun 2003, Geneva 2006).

But among all those, the main problem seems to be, that the WTO still has no single codification, it resembles more a mosaic of several international agreements. Sometimes those agreements are contrary to other commitments (e.g. the IMF). The step towards a legal institution was important, but obviously is not sufficient. The WTO needs stronger enforcement mechanisms, more authority and should be more strongly integrated in other International Institutions like the United Nations. Even if strengthening institutions like the WTO means a loss of sovereignty of the nation states, the interwoven world calls for it.

## Literature

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