

# TRADE LIBERALIZATION AND CONSTRAINTS ON MOVES TO PROTECTIONISM: MULTILATERALISM VS. REGIONALISM

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In this article, two key questions are asked: why has the General Agreement on Tariffs and Trade (GATT) and its predecessor the World Trade Organization (WTO) worked in terms of multilateral tariff reduction and promotion of global trade, and to what extent will it act as a constraint on economic nationalism? To answer these two questions, three themes are laid out in the article: first, the seminal economic model rationalizing the economic logic of the GATT/WTO is assessed; second, the perceived relevance of the GATT/WTO in a world of increasing regionalism is discussed; and third, the robustness of the GATT/WTO legal framework and dispute resolution mechanism is evaluated. The key conclusion is that the underlying economic logic of the GATT/WTO is still relevant, but that enforcement of the cooperative agreement will likely be placed under significant strain with the threat of increased protection, and even a potential trade war.

*Key words:* : GATT/WTO, protectionism, multilateralism, regionalism.

*JEL codes:* F13, Q17.

Since the high-point of global protection following U.S. implementation of the Smoot-Hawley Tariff Act of 1930, successive rounds of trade negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT) have resulted in substantial reductions in manufacturing tariffs by developed countries (Bhagwati 1991; Irwin 1995; Bagwell and Staiger 2002; Rose 2004), as well as commitments in the Uruguay Round of GATT to cut agricultural tariffs and place

constraints on support for domestic agriculture (Anderson 1994). Against this background, the election of President Trump presents a significant challenge to the global trading system. Already, his administration has chosen not to ratify the Trans-Pacific Partnership (TPP), renegotiation of the North American Free Trade Agreement (NAFTA) is ongoing, and the prospects of a U.S.-China trade war have increased. The United States has imposed tariffs on imports of Chinese solar-panels, steel and aluminum, and is threatening to impose tariffs on a range of Chinese goods valued at \$50 billion. In response, China imposed tariffs on imports of U.S. sorghum, processed pork and has also indicated it will impose tariffs on \$50 billion worth of U.S. goods, including aerospace products and soybeans. There is also considerable unpredictability in this administration's trade policy: despite having left TPP, the President recently signaled and then backed away from an interest in its successor, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

These uncertainties pose a particular threat to the agricultural sector. The Doha Round

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of the World Trade Organization (WTO) has been stalled in large part due to disagreements over agricultural issues. Following the Nairobi Ministerial Conference in 2015, WTO members agreed to eliminate agricultural export subsidies as part of a targeted package of agricultural policy reforms (FAO 2017). However, progress made on a broader set of agricultural issues has not been sufficient to close the round (Hufbauer et al. 2015). Agriculture is also central to the ongoing NAFTA renegotiations. While agriculture represents only 7% of total U.S. trade with Mexico and Canada, intra-NAFTA trade is critical for certain agricultural products. For example, approximately one third of U.S. corn and beef exports went to Mexico and Canada in 2016 (Hendrix 2017). If the current administration were to pull out of NAFTA and other trade agreements, it would erase the progress made toward global integration of the agricultural sector.

The rhetoric and actions of both the President and the members of his administration suggest current U.S. trade policy can be characterized as economic nationalism. Despite considerable discussion in the political science literature about its precise meaning (Pickel 2003), the current article follows convention by defining economic nationalism in terms of the doctrine of mercantilism (Sheldon 2018). This is clear from the President's inaugural address:

“We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs. Protection will lead to great prosperity and strength.” (President Trump, January 20, 2107)

In this context, two key questions are asked in this article: how has the GATT/WTO achieved multilateral tariff reduction and promoted global trade, and to what extent will it act as a constraint on economic nationalism? To answer these two questions, the article is divided into four sections: first, the model originally developed by Bagwell and Staiger (1999) to rationalize the economic logic of the GATT/WTO is outlined; second, the approach to trade policy of the current administration is set in the context of this model; third, the perceived relevance of the GATT/WTO in a world of increasing regionalism is discussed; and fourth, the robustness

of the GATT/WTO legal framework and dispute resolution mechanism is evaluated. The two key conclusions of the article are: first, the underlying economic logic of the GATT/WTO is still relevant, but that enforcement of the cooperative agreement will likely be placed under significant strain with the threat of increased protection, and even a potential trade war; and, second, the only logical reason for the United States to pull away from the cooperative game that characterizes the GATT/WTO is that there has been a substantive shift in the political economy of trade policy, combined with the current administration's view of trade agreements as a zero-sum game.

## Background to and Economic Logic of GATT/WTO

### *Success of GATT/WTO*

By some simple metrics, the GATT, and its successor the WTO, has been very successful. GATT/WTO has established a rules-based system for world trade based on a set of principles enshrined in the GATT Articles, along with a dispute settlement system, that have been universally accepted and respected by its members (Baldwin 2016). Membership has grown from the twenty-three countries that signed the GATT in 1947 to 164 countries today. WTO members account for more than 95% of both global trade and GDP (Williams 2008). Over the seventy years of its existence, there have been eight rounds of trade negotiations, resulting in average industrial tariffs being reduced to less than 4%, although it should be noted that there is quite a bit of heterogeneity in the level of bound tariffs across both countries and industries (Bagwell, Bown, and Staiger 2016; Baldwin 2016).

There have been several empirical studies that have explored the relationship between membership of the GATT/WTO and countries' trade flows. The initial finding by Rose (2004) came as something of a shock to trade economists and policy analysts: membership of the GATT/WTO was not correlated with increased trade flows as compared to nonmember countries. Not surprisingly, this generated a body of research seeking to overturn Rose's (2004) result, including, inter alia, Subramanian and Wei (2007), Tomz, Goldstein and Rivers (2007), and Baldwin (2010).

Subramanian and Wei (2007) provide the most robust response to Rose's (2004) findings, their econometric analysis being much more consistent with theoretical treatment of GATT/WTO. Specifically, they argue that the impact of a country's membership of GATT/WTO will depend on three dimensions: first, what a country does with its membership; second, with which other countries a country negotiates; and, third, which products are covered in trade negotiations. Their econometric results are consistent with these predictions: industrial countries that participate in reciprocal trade negotiations enjoy a significant increase in trade, bilateral trade is greater when both countries engage in tariff reduction as compared to when only one country does, and sectors such as agriculture that were not covered by trade negotiations exhibit little or no increases in trade. It should be noted, however, that in subsequent empirical work, Grant and Boys (2012) find that, countries' agricultural trade has been significantly increased by their membership of GATT/WTO.

These results, subsequently confirmed by Chang and Lee (2011) and Eicher and Henn (2011), have been interpreted in the context of differential treatment (SDT) under GATT/WTO rules (Bagwell and Staiger 2014). Specifically, developing-country members of GATT/WTO have been exempted from its reciprocity norm, that is, developing countries get a "free pass" on any tariff cuts negotiated between industrialized countries through the most favored nation (MFN) rule by not being expected to cut their own tariffs. The motivation for SDT is ostensibly that developing countries would be able to gain greater access to developed country markets under MFN. However, Bagwell and Staiger (2014) argue that, by not lowering their own tariffs, developing country resources are retained in inefficient import competing sectors. In a simple general equilibrium setting, this acts as a tax on their export competing sectors, that is, in trade negotiations, ". . . what you get is what you give . . ." (Bagwell and Staiger 2014, p. 99). Therefore, the conclusion to be drawn from the extant empirical research is that membership of GATT/WTO can be characterized as the outcome of a cooperative game that is Pareto-superior in some sense for its members, and particularly those that engage in reciprocal tariff-cutting.

### *Economic Logic of GATT/WTO*

Orthodox trade theory suggests that a small Country should unilaterally cut its tariffs, gains from trade occurring through specialization and exchange. This is not necessarily the case if a country is large enough to influence its terms-of-trade, or if public policy is influenced by government preferences other than maximization of national income. In other words, economic analysis of GATT/WTO is about seeking a logical explanation for why a country would seek to be part of such a trade agreement, despite these unilateral incentives to raise tariffs. We might also ask, if it is Pareto-improving to be part of a cooperative agreement, why would a member undermine that agreement or leave it altogether?

In order to answer the first question, the bare bones of the seminal approach to modeling GATT/WTO is described, the reader interested in more technical details being directed to the considerable body of work by Kyle Bagwell and Robert Staiger (e.g., Bagwell and Staiger 1999, 2002, 2005, 2010, 2014; Bagwell, Bown, and Staiger 2016). Using their notation, the workhorse model for their approach is a simple two-good two-country general equilibrium model, where the home country has a comparative advantage in producing good  $y$ , and the foreign country has a comparative advantage in producing good  $x$ . Local relative prices are  $p \equiv p_x/p_y$  and  $p^* \equiv p_x^*/p_y^*$  in the home and foreign country respectively, while world prices are  $p^w \equiv p_x^w/p_y^w$ , and in the absence of tariffs  $p \equiv p^w \equiv p^*$ . If home and foreign tariffs are  $\tau$  and  $\tau^*$  respectively, market-clearing local and world prices can be written as,  $p = p(\tau, \tilde{p}^w)$ ,  $p^* = p^*(\tau^*, \tilde{p}^w)$ , and  $\tilde{p}^w(\tau, \tau^*)$ , the following conditions being assumed,  $dp/d\tau > 0 > dp^w/d\tau^*$  and  $\partial \tilde{p}^w/\partial \tau < 0 < \partial \tilde{p}^w/\partial \tau^*$ , that is, each country's tariff drives a wedge between local and world relative prices, giving protection to their import-competing sector, but at the same time each country is large enough to be able to improve their terms-of-trade through a tariff. The welfare functions of the home and foreign governments are defined in terms of relative prices,  $W(p, \tilde{p}^w)$  and  $W^*(p^*, \tilde{p}^w)$ , respectively. Given that local prices determine the level and distribution of factor incomes in each country, various government preferences discussed in the political economy literature can be captured, including national income

maximization (Johnson 1953; Mayer 1981), and political lobbying models (Grossman and Helpman 1994, 1995). It is also assumed that holding its local relative price fixed, both home and foreign governments value an improvement in their terms-of-trade,  $W_{\tilde{p}^w}(p, \tilde{p}^w) < 0 < W_{\tilde{p}^w}^*(p^*, \tilde{p}^w)$ .

If there is no trade agreement, the home and foreign countries play out a Nash equilibrium in tariffs, the first-order conditions defining optimal tariffs being:

$$(1) \quad W_p + \lambda W_{\tilde{p}^w} = 0, \\ W_{p^*} + \lambda^* W_{\tilde{p}^w}^* = 0,$$

where  $\lambda = [(\partial \tilde{p}^w / \partial \tau) / (dp / d\tau)] < 0$ , and  $\lambda^* = [(\partial \tilde{p}^w / \partial \tau^*) / (dp^* / d\tau^*)] < 0$ . The expressions in equation (1) reflect the balance that each government strikes with respect to the local and world relative price effects of their tariff choices. In terms of local relative price changes, there is a trade-off between the political benefits of redistribution to factors employed in the import-competing sector and any deadweight losses to domestic consumers. With respect to world relative price changes, the improvement in one country's terms-of-trade necessarily results in a worsening of the other country's terms-of-trade, that is, each country shifts some of the costs of their protection onto the other country.

Essentially, it is the cost-shifting externality that results in Nash equilibrium tariffs being inefficient (Bagwell and Staiger 1999). Given that  $W_p < 0 < W_{p^*}^*$ , each government would like to lower their respective tariffs in order to reduce the domestic distortion and generate more trade, but if done unilaterally they suffer a worsening of their terms-of-trade, given  $\lambda W_{\tilde{p}^w} > 0 > \lambda^* W_{\tilde{p}^w}^*$ . Bagwell and Staiger's (1999) insight is to argue that, if the terms-of-trade externality can be neutralized, it will be Pareto-improving for both countries to lower their tariffs. In other words, suppose that neither country's government cared about terms-of-trade effects,  $W_p \equiv 0$  and  $W_{p^*}^* \equiv 0$ , from equation (1), optimal tariffs will be set to satisfy domestic political objectives, that is,  $W_p = 0$  and  $W_{p^*}^* = 0$ . These tariffs are termed "politically optimal tariffs," which would either be zero if each government seeks to maximize national income through free trade, or they would be positive in order to satisfy domestic political-lobbying constraints, but importantly, they are lower

than Nash equilibrium tariffs. Therefore, if countries enter into a trade agreement, they will seek mutual reductions in tariffs that will generate a Pareto improvement, with equilibrium tariffs being located on the efficiency locus. Necessarily, "politically optimal" tariffs satisfy this condition, but they are only one of several tariff combinations on the efficiency locus.

Given this model structure, Bagwell and Staiger (1999) argue that application of the principle of reciprocity in GATT/WTO does result in welfare-improving tariff reductions. Specifically, reciprocity means that for either country to offer a tariff concession, it requires a tariff concession from the other country such that the world relative prices remains unchanged, that is, terms-of-trade effects are ruled out. Tariff-cutting continues until one of two conditions is satisfied: one country's government achieves its preferred local price before the other, that is,  $W_p = 0, W_{p^*}^* \neq 0$  or  $W_p \neq 0, W_{p^*}^* = 0$ ; politically optimal tariffs" are achieved, that is,  $W_p = 0$  and  $W_{p^*}^* = 0$ . Of course, the idea that trade negotiators are concerned with the technicality of terms-of-trade effects is likely unrealistic, but as Bagwell and Staiger (2010) point out, this concept can be expressed in terms of market access. A tariff, while creating a terms-of-trade benefit for the importing country, also results in a loss of market share for the exporting country. In other words, from a practical standpoint, trade negotiations are about mutual concessions on market access.<sup>1</sup>

Reciprocity also helps explain the idea behind "withdrawal of equivalent concessions" as part of the dispute settlement mechanism of GATT/WTO. Standard game theory would suggest that both home and foreign countries have an incentive to deviate from the low-tariff equilibrium that results from a trade agreement. Consequently, in a standard repeated game, the punishment for not adhering to a trade agreement is reversion to the static Nash tariff equilibrium, that is, a trigger strategy (Zissimos 2007). In practice, the rules of GATT/WTO seek to maintain the balance of concessions and avoid the use of punitive actions (Staiger 1995). Essentially, if the home country were to raise its bound

<sup>1</sup> There is a growing body of empirical evidence supporting the terms-of-trade theory of trade agreements, e.g., Broda, Limão, and Weinstein (2008), Bagwell and Staiger (2011), Bown and Crowley (2013), and Dhingra (2014).

tariff, this would imply a loss of previously negotiated market access for the foreign country. Assuming that this action is not “abusive,” under GATT/WTO rules, the foreign country is allowed to withdraw an amount of market access equivalent to what the home country has withdrawn, a punishment path that is subgame-perfect (Zissimos 2007). However, if the home country deviates in an “abusive” manner, there is reversion to the trigger strategy, that is, there is an indefinite suspension of GATT/WTO obligations, both home and foreign countries setting Nash tariffs (Zissimos 2007).<sup>2</sup> In other words, the objective of GATT/WTO rules is to ensure that retaliation by one country against the unilateral action of another is proportionate, thereby minimizing the chance of a trade war.

As well as reciprocity, the principle of non-discrimination in GATT/WTO also requires that tariffs be applied on an MFN basis, that is, in the simple model, if the home and foreign country agree to lower their tariffs, those tariff cuts should be extended to any other country that is a member of GATT/WTO. Importantly, MFN in combination with reciprocity can minimize the risk of third-country spillovers (Bagwell and Staiger 2005, 2010). Suppose the home country exports good  $y$  to two foreign countries, and imports good  $x$  from both countries. In addition, the home country may consider setting discriminatory tariffs on its imports of good  $x$  from the two foreign countries. In this case the composition of trade volume matters; that is, the home country would want to import more from the foreign country on which it imposes a higher tariff, export market shares of the two foreign countries depending on their specific world and local relative prices. Consequently, MFN removes any local relative price effects due to discriminatory tariffs, leaving a single world relative price as the only mechanism through which tariffs can create externalities.

In a multilateral setting, MFN allows for reciprocity to be applied in a sequence of bilateral bargains between countries where the risk of concession erosion is eliminated (Bagwell and Staiger 2010). Suppose that the home country chooses to enter into reciprocal tariff reduction with foreign country 1, but

each offers their respective tariff cuts to foreign country 2 under MFN. The end result is that given foreign country 2 keeps its tariff fixed, negotiations between the home and foreign country 1 under MFN ensure that there is a single world relative price that remains unchanged, that is, foreign country 2 experiences no change in its export volume. It should be noted, however, that without reciprocal tariff cuts by the home and foreign country 1, the world relative price will change, thereby affecting foreign country 2’s export trade volume—in other words, MFN on its own is not sufficient to prevent concession erosion.<sup>3</sup>

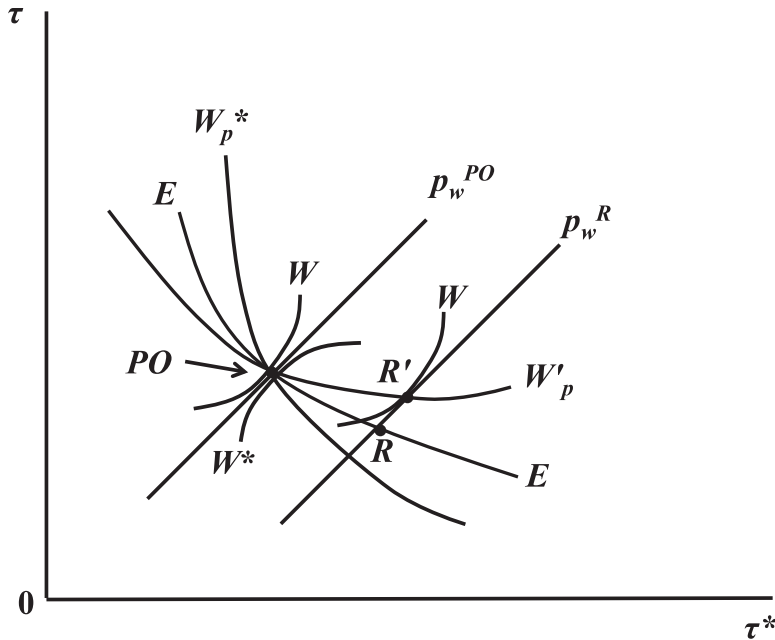
### Economic Nationalism in the Context of GATT/WTO

Is it possible to rationalize the trade policy approach of the current administration in the context of this large body of theoretical and empirical evidence on the GATT/WTO? If the existing tariff equilibrium is on the efficiency frontier, and has until now been politically optimal, there are no obvious gains to economic welfare to unilaterally raising tariffs, that is, it should be renegotiation-proof (Bagwell and Staiger 1999). However, it is possible that the existing tariff equilibrium, while on the efficiency frontier, is no longer politically optimal, and is, therefore, not renegotiation proof. Given sufficient domestic political changes within the United States, it might be optimal for the current administration to withdraw some tariff concessions under GATT Article XXVII, after which the affected country(ies) would be permitted to withdraw equivalent concessions.

These two arguments are described in figure 1. Given home U.S. and foreign country tariffs,  $\tau$  and  $\tau^*$ ,  $EE$  is the efficiency locus,  $PO$  and  $R$  describing two specific efficient tariff combinations. The relevant iso-world-price loci,  $p_w^{PO}$  and  $p_w^R$ , run through these two tariff combinations, that is, neither country’s terms-of-trade vary along these loci. Finally, the loci along which tariffs result in  $W_p = 0$  and  $W_{p^*} = 0$  are shown for the United States and foreign country, respectively. These loci only intersect at the politically optimal point  $PO$  where there is a multiple tangency between

<sup>2</sup> From a game-theoretic standpoint, these results draw on Friedman’s (1971) “Nash-threats” theorem, i.e., if the foreign country withdraws more than an equivalent amount of market access, this will trigger indefinite imposition of Nash tariffs.

<sup>3</sup> Empirical evidence supporting the reciprocity and non-discrimination principles in GATT/WTO negotiations can be found in Bown (2004), and Limão (2006, 2007).



**Figure 1. Tariff equilibrium**

the iso-welfare contours  $W$  and  $W^*$  and the iso-world price locus  $p_w^{PO}$ . If the U.S. economy has actually reached this point after successive rounds of trade negotiations, it cannot be Pareto-improving for it to raise its tariffs unilaterally, that is, it is renegotiation proof.<sup>4</sup>

Suppose instead that the U.S. economy starts at a point such as  $R$ , the locus  $W_p$  (not shown) being sufficiently close to  $R$  such that at the margin, there is no incentive to withdraw any tariff concessions. Suppose instead that the current U.S. administration has different political objectives to those held by the previous administration, the locus being  $W'_p$ . This puts pressure on the United States to withdraw some tariff concessions, the foreign country responding by withdrawing equivalent concessions in such a way as to preserve the world price ratio at  $R'$  where the United States now maximizes welfare. Under these circumstances, there may be a rationale for the United States to withdraw tariff concessions, but its willingness to do so is constrained by the retaliation allowed to the foreign country by the GATT/WTO rules.<sup>5</sup>

<sup>4</sup> Bagwell and Staiger (1999) show formally that politically optimal MFN tariffs are also renegotiation proof under reciprocity.

<sup>5</sup> If political objectives have changed at the initial equilibrium  $R$  in figure 1, it is not an empty threat for the US to seek to move

to  $R'$ . It increases its welfare at the expense of the foreign country, even though the latter withdraws equivalent concessions, thereby maintaining world relative prices. Of course to avoid such renegotiation, both countries should have sought a tariff equilibrium closer to  $PO$  in the first place. Also, a significantly larger deviation from  $R$  by the United States will provoke a trigger strategy by the foreign country, pushing tariffs to the Nash equilibrium.

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$$(2) \quad \tau_j^h - \tau_j^f = \frac{I_j^h}{a^h \cdot \eta_j^h \cdot \frac{m_j^h}{y_j^h}} - \frac{I_j^f}{a^f \cdot \eta_j^f \cdot \frac{m_j^f}{y_j^f}},$$

where  $I_j^k = 1$  if a lobby exists in the sector producing good  $j$ ,  $a^k$  is the weight attached to social welfare,  $a^k \leq \infty$ ,  $\eta_j^k$  is the price elasticity of import demand (export supply) for good  $j$ , and  $m_j^f/y_j^f$  is the market share of imports (exports) for good  $j$ . The intuition of equation (2) is straightforward: if good  $j$  is an import/export for the home/foreign country, the net policy outcome of the trade agreement is very sensitive to whether there is a lobby in industry  $j$  and also the weight attached to social welfare. Therefore, drawing on this model, the United States could be seeking to increase the tariff in an import-competing sector where either a lobby has become active, and/or less weight is being attached to social welfare, that is, the dead-weight costs imposed on individual voters are not weighed as heavily in the policymaker's decision calculus. Of course, by the logic of reciprocity, the foreign country will also seek to increase the tariff in its import-competing sector, in order to maintain the balance of concessions made in the original trade agreement.

However, this argument is difficult to reconcile with empirical research by Fajgelbaum and Khandelwal (2016), who find that the burden of increased protection is likely to fall disproportionately on individuals at the lower end of the income distribution, many of whom likely voted for President Trump. In addition, if the U.S. import-competing industry has been long in decline, by the logic of Freund and Özden (2008), the level of protection should be declining not increasing, as sensitivity to losses in the sector diminishes, an argument they support empirically with reference to the U.S. steel industry.

Interestingly, under the Trade Expansion Act of 1962, Section 232, the current administration has authorized tariffs to be levied on U.S. steel imports due to a perceived threat to national security, and the argument that excess capacity in the Chinese steel sector has resulted in their dumping steel on the world market (Bown 2018), that is, the current administration is seeking to push  $\tau_j^h - \tau_j^f \geq 0$ . The Chinese have already responded proportionately by levying tariffs on an equivalent amount of imports of U.S. goods such as processed pork, and Japan has also

threatened retaliation if they are not exempted from the tariff (Fujikawa 2018; Li, Zhang, and Hart 2018). The latter raises an interesting point: initially, the tariff was targeted at all major exporters of steel to the United States, but since its announcement, permanent exemptions have been agreed with Argentina, Australia, and Brazil, and imposition has been postponed in the cases of Canada, the European Union, and Mexico; that is, the United States is acting in a discriminatory manner in its application of steel tariffs (Lawder 2018). However, if the current administration is doing this to manipulate both world and local relative prices in order to extract maximum tariff revenue, why not target tariffs at the largest suppliers of steel to the United States such as Canada and the European Union, as opposed to a relatively small supplier such as China? Of course, the current administration may be using the threat of steel tariffs against Canada and Mexico in order to extract concessions in the NAFTA renegotiations as opposed to explicit bilateral opportunism.

A second possibility is that the United States is seeking to rebalance trade with countries with whom it has a bilateral trade deficit, the objective being to negotiate "more reciprocal" tariffs with such countries. For example, the current administration seems to believe that reciprocity should result in uniform reciprocal tariff rates, that is, if the United States has a tariff rate of 2.5% on automobiles, then China should also have a 2.5% tariff on automobiles (Bown, Staiger, and Sykes 2017). However, this view does not appear to recognize the exact nature of reciprocity in GATT/WTO which incorporates the notion of "first-difference" reciprocity, i.e., "... tariff cuts are to proceed via bargaining that reflects a balance of perceived advantage at the margin rather than by ... perceived full equality of market access and reverse market access (or what in modern American parlance, is pithily described as 'level playing field') . . ." (Bhagwati 1988, p.36).

Third, it is possible that the current administration does not fully appreciate the GATT/WTO "latecomers" problem. While developing countries such as Brazil, India, and China might like to offer tariff cuts in the GATT/WTO, developed countries such as the United States do not have much to offer in new rounds of reciprocal tariff-cutting, that is, there is essentially "globalization fatigue"

(Bagwell and Staiger 2014). Bown, Staiger, and Sykes (2017) argue that the way to approach this problem, is not through “leveling the playing field,” that is, unilaterally threatening to raise tariffs if developing countries such as China do not lower their tariffs but instead seek a new reciprocal trade bargain within the GATT/WTO. Bagwell and Staiger (2014) address this issue in terms of how to “make room” for the developing countries at the GATT/WTO table. Specifically, they argue that the traditional reciprocal exchange of market access through tariff concessions will have to be replaced with an approach that involves developed countries lowering/eliminating their agricultural export sector subsidies, thereby improving the terms-of-trade of developing country agricultural exporters, in exchange for which developing countries reduce their tariffs on imports of manufactures.

The overall conclusion to be drawn is that the current administration’s objective function differs from those of previous administrations. While previous administrations participated in decades of successful rounds of multilateral tariff cuts, the current administration is following a path of economic nationalism and pushing back with threats of not playing by the accepted rules of international governance. The approach of the current administration is to address what they see as “unfair trade practices” by following unilateral policies, renegotiating or withdrawing from trade agreements, and threatening to apply import protection (Handley and Limão 2017). Essentially, President Trump believes that his approach to bargaining will be much more likely to get a “better deal” for the United States (Bown, Staiger, and Sykes 2017). In other words, rather than being the win-win of reciprocal and multilateral exchange of market access as a resolution to an inefficient Nash tariff equilibrium, it would seem that trade agreements are instead perceived as a zero-sum game, where until now, the United States has typically lost, and its trading partners have won.

This view of trade agreements certainly appears to characterize the current administration’s attitudes towards dispute settlement within GATT/WTO, where it has been blocking the appointment of judges to the WTO’s Appellate Body (Keynes and Bown 2017). Essentially, the current administration feels that in the WTO’s dispute settlement process, the United States is being denied the benefits

it signed up for. Specifically, U.S. Trade Representative Robert Lighthizer is of the view that these benefits included the right to impose anti-dumping duties, and the fact that the United States has lost a significant number of cases involving anti-dumping actions, means that the judges are denying the United States its benefits (Wroughton 2017).

However, this conclusion seems to be based on a narrow reading of the history of the WTO’s dispute settlement process. In fact, the WTO’s dispute settlement system was developed during the Uruguay Round at the insistence of the U.S. Congress (Payosova, Hufbauer, and Schott 2018). The United States has made frequent use of the system, initiating or participating in 112 complaints between 1995 and 2016. Of course, the United States has also been a frequent target of complaints, responding to a total of 130 over the same period (Leitner and Lester 2017). Those skeptical of the WTO argue that its dispute settlement process is biased against the United States, citing the fact that the United States has lost approximately 90% of the adjudicated cases where it was named as a respondent (Stewart and Drake 2017). This ignores the fact that the United States has also won approximately 90% of the adjudicated cases in which the United States was a complainant (Ikenson 2017). Rather than indicating an anti-U.S. bias, this indicates that governments are strategic in which cases they allow to go through adjudication. In fact, almost two thirds of all disputes raised are settled voluntarily without ever being adjudicated in the formal dispute settlement process (Johannesson and Mavroidis 2016).

## Regional Trade Agreements

At the same time that the current administration has expressed skepticism about multilateral trade agreements, they have demonstrated an interest in negotiating smaller, especially bilateral, trade deals (Porter 2017). One notable example is the ongoing effort to renegotiate NAFTA. Although the current administration has expressed a willingness to walk away from NAFTA if they are not satisfied with the process (Gillespie 2017), the negotiations continue. This stands in stark contrast to



withdrawal from TPP in January of 2017 without any attempt to renegotiate the deal.

The current administration's decision to renegotiate NAFTA but not TPP is puzzling when comparing the content of TPP with the current administration's NAFTA renegotiating objectives. Both include increases in market access for American goods, and both include so-called "deep integration" measures, also known as "WTO-extra" provisions. These commitments extend beyond the areas covered by the GATT/WTO. They typically target the harmonization of domestic regulatory standards, including labor and environmental standards as well as protection for foreign investors and intellectual property. These have become the target of trade negotiations as firms increasingly rely on "offshoring" some parts of their production processes to other countries in order to reduce costs. Today, approximately 40% of the value of exports is derived from imports, and trade in intermediate goods represents over half of all merchandise trade (Lamy 2014). "Deep integration" would help firms avoid the costs of dealing with inconsistent regulatory standards across multiple countries.

Deep integration has become important for U.S. farmers as agricultural supply chains have stretched across national borders, the pork industry being a telling example. In 2014, approximately 4.9 million pigs were imported into the United States from Canada. These pigs were finished with cheap U.S. corn and soybean meal on farms in the Midwest before finally being slaughtered and processed in U.S. facilities. Some of the resulting pork products were then re-exported to Canada and Mexico (Hendrix 2017). The central importance of these trade agreements to U.S. agriculture has led several agricultural industry groups to express concern over the Administration's approach to trade negotiation. After the current administration announced it would pull out of TPP, the National Cattlemen's Beef Association (NCBA) issued a press release expressing concern that the Trump administration was acting "... without any meaningful alternatives in place that would compensate for the tremendous loss that cattle producers will face without TPP or NAFTA" (NCBA 2018). Similarly, the American Farm Bureau Federation (AFBF) has stated that the current NAFTA renegotiation "... must protect gains achieved in agricultural trade and work

to remove remaining barriers to trade with Canada and Mexico" (AFBF 2017).

One way to interpret President Trump's skepticism toward the WTO and (begrudging) embrace of NAFTA is simply as an extension of the global trend away from multilateralism toward Regional Trade Agreements (RTAs). Although President Trump's particular brand of regionalism may be more accurately described as bilateralism. This may reflect a bias identified by Bhagwati (1994) as the tendency of U.S. politicians to "... mistakenly identify multilateralism with America's postwar altruism" (p. 29). Movement toward RTAs might be seen as an attempt to act in the U.S.'s own best interests. Whether this engagement with RTAs will ultimately lead to progress on multilateral trade agreements is still an open question.

#### *Will RTAs Lead to Multilateral Trade Liberalization?*

Since the early-1990s there has been a rapid expansion in the number of RTAs, 445 being in force by 2017 (WTO Secretariat 2017). This shift to regionalism has led economists to consider whether or not RTAs increase global economic welfare, that is, in the words of Bhagwati (1994), are they "building blocs" or "stumbling blocs" toward multilateral trade liberalization? Ever since Viner (1950), economists have been skeptical of the efficiency implications of RTAs. Although RTAs reduce trade barriers, they are, by definition, discriminatory, granting concessions to only a select few trade partners. RTAs may reduce global welfare if they lead to trade diversion, which occurs when RTA members import from less-efficient producers inside the agreement rather than the more efficient producers outside the agreement. Discriminatory tariff cuts can also create opportunities for "bilateral opportunism" (Bagwell, Bown, and Staiger 2016). Bilateral opportunism exists when two parties to an RTA agree to reduce tariffs on each other's goods, improving their terms-of-trade at the expense of excluded partner(s). As noted earlier, concerns like these are why MFN has been central to the GATT/WTO since its inception.

Aghion, Antràs, and Helpman (2007) provide a framework to understand trade negotiations where a leading country such as the U.S. either bargains multilaterally with all other countries simultaneously or

sequentially negotiates RTAs with subsets of countries which may or may not lead to a multilateral agreement, termed a “grand coalition.” Assuming all countries maximize aggregate economic welfare (national income plus consumer surplus), and the leading country is willing to make side payments to other coalition members, it is shown that RTAs will generally be building blocs toward a multilateral agreement.<sup>6</sup> As long as the benefits of the grand coalition are greater than either the sum of the benefits under no agreement, or the sum of the benefits under an RTA excluding at least one country, RTAs will eventually lead to a multilateral agreement. Importantly this result holds regardless of whether or not an initial RTA generates a price “externality.” If an initial coalition lowers (raises) the world price of the good exported by an excluded country, the leading country will prefer sequential (multilateral) bargaining in order to minimize the size of its side payments, the equilibrium trade agreement being multilateral.

The result that RTAs are not stumbling blocs to multilateral agreements is conditional on markets being competitive as well as policymakers maximizing a country’s aggregate economic welfare. To understand this, we can draw again on Grossman and Helpman’s (1994, 1995) model of trade policy formation as the outcome of competition among domestic interest groups. In their full model, policymakers maximize a weighted sum of aggregate economic welfare and the welfare of industry-specific interest groups whose members can earn additional profits from trade policies offered by politicians seeking campaign contributions.

Political competition among special interest groups, both inside and outside the RTA, can lead to a “domino effect” that draws more and more countries into the agreement (Baldwin 2006). If it is assumed that the country starts in political equilibrium, an exogenous shock that expands the RTA will expand exporting sectors in member countries states relative to import-competing sectors. This translates into a shift in the relative sizes

of their campaign contributions, and political movement towards expanding the RTA. If expansion of the RTA imposes negative externalities on the remaining nonmembers, that is, through terms-of-trade effects, this will also strengthen the special interest groups pushing to join the RTA within non-member countries.

However, as Aghion, Antràs, and Helpman (2007) note, this kind of political competition does not guarantee that RTAs will always expand to form multilateral agreements. An RTA might actually prevent the formation of a multilateral agreement if the RTA imposes positive externalities on the excluded country. Suppose that the leading country along with a second country both import a good from a third country, the second country imposing a higher tariff. If the leading country and the second country form an RTA, the price of the good falls in the second country relative to the leading country, resulting in increased import demand from the newly-expanded RTA, and an increase in the world price. As a consequence, profits earned by pro-trade political interest groups rise in both the leading country and excluded country but fall in the second country due to the fact that the increase in the world price does not compensate its political interest groups for the reduction in its level of protection. Politicians in the leading country prefer this outcome to that of a multilateral agreement because the payoff to its special interest groups is higher than under a multilateral agreement where profits would fall; therefore, no further expansion of the RTA is likely to occur.

#### *Future Negotiations*

Will the current administration’s focus on bilateral and regional trade deals ultimately produce a multilateral agreement? Its willingness to renegotiate NAFTA at least shows that progress can be made toward lowering trade barriers between the US and its partners. However, the current administration’s unwillingness to negotiate multilaterally or in mega-regionals such as TPP may ultimately be self-defeating. There is a real danger that RTAs will stop the progress of multilateral negotiations. While the current administration may believe it can achieve “a better deal” in bilateral or small regional trade deals, only multilateral negotiations can fully realize the gains from trade.

<sup>6</sup> Side payments among the members of existing RTAs can be rationalized in terms of an exchange of concessions on non-trade related issues such as agreements on product and labor standards (Aghion, Antràs, and Helpman 2007). Side payments help ensure the expansion of customs unions by transferring a portion of the gains from expanding the RTA to the losers among the existing RTA members. Without these mechanisms, RTAs are more likely to stall Bhagwati (1992).

## WTO Dispute Settlement and Protectionism

Although the U.S. political objective function seems to have changed, the institutional features of the WTO have not. The WTO dispute settlement system is considered to be one of the WTO's crowning achievements. It ensures reciprocal and proportionate responses when countries fail to uphold their obligations under the WTO. It is difficult to quantify exactly how effective the dispute settlement mechanism has been. First, most disputes are settled without being adjudicated. Second, WTO members may disagree about whether or not an action constitutes compliance with a dispute settlement ruling. Finally, respondents may not fully comply with a ruling, but complainants may choose not to press the issue because some other arrangement has been made among the parties. In 2013, the outgoing chair of the Dispute Settlement Body (DSB) estimated the compliance rate (broadly defined) among WTO members to be 90% (Bashir 2013).

However, the dispute settlement system may be less effective in an era of rising economic nationalism as exhibited by some of the policies of the current administration. To understand why this is the case, we must start with a basic understanding of how the dispute settlement system works to resolve trade disputes. The ultimate goal of the dispute settlement system is to bring a non-conforming measure, law or regulation issued by a WTO member into compliance with the obligations of the WTO as set forth in its agreements. All other types of remedies, such as compensation or retaliation (both further explained below), are seen as temporary measures with the goal of inducing compliance.

### *WTO Dispute Settlement and Trade Remedies*

To bring an action within the dispute settlement system, the complaining party must show a "nullification or impairment" of a trade benefit in order to assert a viable claim against an offending party. One can view this as a requirement that the complaining party must show an injury cognizable under the WTO. This is the standard that is adopted in the WTO Dispute Settlement Understanding (DSU):

General Agreement on Tariffs and  
Trade Article XXIII  
Nullification or Impairment

1. If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of
  - a. the failure of another contracting party to carry out its obligations under this Agreement; or
  - b. the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or
  - c. the existence of any other situation,

the contracting party may, with a view to the satisfactory adjustment of the matter make written representations or proposals to the other contracting party or parties which it considers to be concerned. Any contracting party thus approached shall give sympathetic consideration to the representations or proposals made to it.

To begin with, note that under Article XXIII, an action cannot be brought before the WTO DSB until a "nullification or impairment" of a benefit has already occurred. In other words, the WTO dispute settlement system does not contemplate any type of relief to prevent an injury; in general, the injury must have already occurred before any relief is possible. Contrast this position with a domestic legal system such as that of the United States in which it is possible under the right circumstances to obtain injunctive relief to prevent an injury from occurring when such a possibility is imminent. The WTO lacks the power to issue injunctive relief to prevent a harm from occurring; this type of relief is not possible within the WTO and this can be considered one of its shortcomings. The result of this deficiency in the WTO is that the global trading system must have first suffered a trade distortion in the form of a protectionist trade measure before any type of relief can be sought. The relief that is sought must then undergo a set of procedures and a decision-making process that can last several years before a decision is reached.

Now assume that the current administration makes a sudden unilateral decision to raise tariffs on imports above the bound WTO rate. The United States is implementing

a new set of protectionist measures meant to protect local industry from import competition. In this situation, the nation that is subject to the sudden increase in tariffs on its imports can assert the “nullification or impairment” of a trade benefit, that is, the U.S. decision to impose a higher tariff than the bound WTO rate. The nullification or impairment is the result of U.S. failure to carry out its obligations under the WTO to apply the WTO tariff rate (GATT Article XXIII(1)(a)). The aggrieved nation can then bring an action within the WTO dispute settlement system subject to the rules of the WTO DSU. Further assume that the aggrieved nation wins the WTO case and the WTO issues a decision finding that the United States is in violation of its WTO obligations. In this event, the WTO dispute settlement body will “recommend” that the United States bring the offending measure, that is, the higher tariff, into compliance with its WTO obligation, that is, the United States lowers the tariff rate to the lawful WTO rate. At this point, under the WTO procedures, the United States has a reasonable period of time to comply with the recommendations of the DSB (DSU Article 21.3).

If the United States fails to follow the recommendation of the DSB within a reasonable time by removing the offending higher tariff, the aggrieved party can seek compensation from the offending party (DSU Article 22.2). Providing compensation is a voluntary decision on the part of the offending party, the United States in this hypothetical case. Compensation in this context does not refer to a monetary payment but the granting of additional concessions on the part of the offending party to benefit the aggrieved party. For example, the United States could agree to impose zero tariffs instead of the bound WTO rate on certain imports from the aggrieved party, which would provide a financial benefit or compensation to the aggrieved party. As compensation is a voluntary measure on the part of the offending party, the current administration might refuse to provide compensation. At this point, the aggrieved party can seek authorization from the DSB to impose countermeasures in the form of suspending trade concessions, such as low tariffs on U.S. imports, given to the offending member (DSU Article 22.3). Although the WTO uses the term “countermeasures,” this is really a form of trade retaliation. The aggrieved member can ask for and may receive

authorization to impose higher tariffs on imports from the United States. Retaliation, like compensation, is viewed by the WTO as a form of political pressure to induce the offending member to bring its non-conformity measure into compliance with its WTO obligations. In other words, retaliation, like compensation, is meant to induce the United States to lower its tariffs.

Trade retaliation is viewed as an extreme measure and is rarely invoked, but trade retaliation is problematic and may be the weakest part of the WTO dispute settlement system, at least in relation to powerful states. Trade retaliation may create effective pressure on weaker trading states to comply with the WTO, but trade retaliation creates the possibility that powerful states, such as the United States, will refuse to comply for many years and simply live with retaliation. This policy could mean that in the event of a trade dispute arising from the current administration’s imposition of higher tariffs as a protectionist measure, the current administration will ignore any adverse decision of the WTO and simply live with the consequences of any WTO authorized trade sanctions. Living with trade retaliation, while arguably against the spirit of the WTO is in line with its letter. In fact, the current administration might further escalate trade tensions by imposing additional protectionist trade measures as a form of counter retaliation against the aggrieved country.

#### *The WTO as an Ineffective Deterrent against Trade Protectionism*

The structure of the WTO dispute settlement system is based upon the good faith of the WTO members, peer pressure, and an overall desire of all WTO members to maintain the viability and credibility of the WTO system. In the event that a powerful country such as the United States is determined to impose protectionist measures that promote its own view of economic nationalism as opposed to multilateralism as the basis of the modern trading system, there is little that the WTO can do. A powerful country like the United States can simply decide to live with any sanctions authorized by the WTO, an option that is permitted under the DSU. The WTO dispute settlement system, as presently organized, will not be able to operate as an effective deterrent to the type of nationalistic

policies that the current administration has announced that it intends to follow.

## Conclusion

The election of Donald Trump as U.S. President has resulted in adoption of economic nationalism in the form of mercantilism. The approach of the current administration is a radical departure from that of previous administrations and is in fundamental tension with the GATT/WTO. The basic approach of the GATT/WTO has been shown to be remarkably successful in reducing trade barriers and in increasing trade volumes through eight successive rounds of trade negotiations and through the widespread implementation of GATT/WTO obligations, such as reciprocity and MFN. The key conclusion of this article is that the economic logic of the GATT/WTO is still relevant and effective and, if undisturbed, should continue to result in future trade liberalization and increases in trade volumes. However, the adoption of economic nationalism by the Trump administration poses a significant threat to the continuing function of the GATT/WTO system.

Underlying President Trump's economic nationalism is a basic departure from the orthodox view that trade is a positive-sum game with mutual benefits for all or most nations that abide by the rules set forth in the GATT/WTO. Replacing this is the view that trade is a zero-sum game, and as a consequence, the current administration is seeking to influence its terms-of-trade in a way that will allow the United States to benefit at the expense of its trading partners. A key finding of this article is that there is a major contradiction in this approach: in seeking to satisfy his political base through implementing tariffs on U.S. imports of goods such as steel and aluminum, President Trump also stands to reduce that same base's purchasing power through tariffs on a range of imports from China. While extant political economy models do recognize that members of lobby groups also consume traded goods, future research might be focused on developing a better understanding of whether it is ever politically optimal to pursue trade policy that simultaneously benefits and hurts a subgroup(s) of voters.

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