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Too Smart for Their Own Good! Complexity, Capacity and Credence in Trade Negotiations

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Multilateral trade negotiations are, by design, becoming increasingly complex. The current degree of complexity limits the ability to assess the effects of a potential agreement and inhibits the transparency needed to reach an agreement. Despite the considerable recent efforts at capacity building in developing countries, the additional complexity has outstripped the ability to build capacity. This article draws upon New Institutional Economics to examine the effects of complexity on trade negotiations. The conclusion is that the rational decision of many countries may be to opt for no agreement.

Keywords: complexity, credence, experience, negotiations, trade

So here's a radical thought to discard if you choose: Would it in fact not be better to use a different approach entirely: drop the tiered approach, drop the complicated flexibilities, two-third proportionalities, all the specials debate etc. etc. all of which threatens to amount to an ever more complicated and ever-cascading exercise in stalemate negotiation and counterbalancing complications. And just go to something more simple and straightforward and, above all, clear: where everybody knows what they are doing and which, quite frankly, most developing Members could probably reasonably manage given what is going on in the real world.

Ambassador Crawford Falconer,
Chairperson of the Agriculture Negotiations
Doha Round, April 30, 2007¹

Introduction

In the New Institutional Economics paradigm, information plays an important role. Unlike neoclassical economics, where all economic actors are assumed to have perfect information and, hence, are not able to use information to strategic advantage, New Institutional Economics recognizes that asymmetric and incomplete information lead to situations where parties can behave opportunistically to secure an advantage, and resources must be expended – transaction costs incurred – to limit vulnerability (Hobbs, 1996). Obtaining information can be a costly activity and these costs factor into decisions. If transactions are complex they are often governed by closely specified contracts that attempt to reduce information asymmetry and provide for contingencies when information is incomplete. Goods that undergo transactions can be classified according to the information that is available to buyers at the time a decision to purchase must be made (Nelson, 1970; Darby and Karni, 1973). *Search goods* are those for which the consumer can determine quality through visual inspection prior to entering into the transaction (e.g., a shirt that can be examined in a retail outlet). *Experience goods* are those where the buyer cannot determine the quality of the good prior to purchase, but rather can only determine quality by consuming the good (e.g., the quality of a steak can be determined only by eating the steak). While mistakes can be made with experience goods, a bad experience may lead to different purchasing decisions in the future (e.g., switching to an alternative brand of steak or possibly to chicken). In the case of *credence goods*, the consumer cannot determine quality even after consumption (e.g., whether the tortilla consumed was made with genetically modified corn or whether the running shoe being worn was produced using child labour) (Gaisford et al., 2001). If the transaction costs associated

with obtaining sufficient information are too high for a potential party to a transaction, then the transaction may never take place (e.g., the consumer may simply stop consuming all corn or not buy the running shoe). Labelling, often certified by a credible independent institution, is required to signal quality in the case of credence goods (e.g., “no animals used in the testing of this product”, “does not contain genetically modified corn”) (Hobbs, 2006).

While New Institutional Economics is often seen as a branch of Industrial Organization in economics, it can yield additional insights into a wide range of institutional arrangements.² Trade agreements are also institutions and their “grand bargains” have characteristics similar to complex contracts.³ This article explores what insights might be gained from examining trade negotiations through the New Institutional Economics lens.

Trade Agreements, Information and Transaction Costs

Over time, trade agreements have increased in complexity. In the era when there were no multinational institutions governing international trade rules, governments were relatively unconstrained in their policy making, both for trade policy and domestic policy. With virtually no constraints except the threat of bilateral *beggar-thy-neighbour* trade retaliation,⁴ governments tended to use transparent and simple mechanisms to provide protection – tariffs for example.⁵ During the Great Depression of the 1930s, countries put in place very high tariffs in ill-fated attempts to protect jobs. The era of high tariffs roughly coincided with the Keynesian revolution in macroeconomics and the substantial increase in the role of government in the economy that followed it (Kerr, 2007a). Given the high tariff walls insulating large segments of their economies from international markets, governments were able to put in place a plethora of subsidies, regulations and redistributive policies without regard for their effect on international trade.

At the end of the Second World War most countries still retained the high tariff barriers that had been put in place during the Great Depression and, for a number of reasons, a mechanism for opening up international commerce was seen as desirable by the victors, who were attempting to construct a set of international institutions to reduce the likelihood of future conflicts in international relations.⁶ While a comprehensive International Trade Organization (ITO) was negotiated, it was stillborn due to a lack of enthusiasm for it in the U.S. Congress.⁷ One of the ITO’s subagreements, the General Agreement on Tariffs and Trade (GATT), which was primarily a mechanism for establishing rules for border measures and the reduction of

tariffs, was acceptable to the U.S. Congress and became the *de facto* multilateral rule-making institution for international trade.

Initially, the limited reach of the GATT, with its focus on tariff reduction, was not a problem because trade liberalization pertained primarily to reducing tariffs. Considerable progress in reducing industrial tariffs was made in the early rounds of GATT negotiations (Miner, 2007). The number of countries was sufficiently small that tariff concessions could be requested and offered on a bilateral basis and subsequently extended to all members on a *most favoured nation* basis. Hence, the GATT negotiations in the early rounds were similar to *search goods*, in that the parties to the negotiations were able to assess the likely economic effects prior to accepting the agreement and, where needed, requests and offers could be revised. As tariffs are transparent policy measures, assessing the likely economic effects was not a resource-intensive activity – the transaction costs associated with obtaining information were not high. While the negotiations were time consuming, progress was relatively easy.

The success of the GATT in reducing tariffs, however, began exposing the trade-distorting effects of other government policies and regulations. As a result, the limitations of the narrow focus of the GATT in achieving trade liberalization became increasingly apparent, and reforming the GATT and expanding its scope increased the complexity of the negotiations. The negotiating rounds consistently increased in length.⁸ Further, given that members had agreed to restrict their use of tariffs – *bound* so that they could not be raised – faced with the normal requests for protection from vested interests, politicians wishing to respond had to resort to less transparent forms of trade-restricting measures, such as technical standards and sanitary and phytosanitary measures. The GATT had to be strengthened in these areas.

Rounds also increased in length due to the GATT's expanding membership, and the bilateral request and offer system became increasingly onerous. The economic assessment of requests and offers became increasingly costly, although this rise in costs was mitigated to some extent by the information processing capacity of the computer revolution. Large computer models were developed to provide assessments of potential agreements.

The early GATT negotiations had also been relatively easy because *waivers* from the general rules were granted, or special arrangements were made, for sectors that were especially contentious, particularly agriculture and textiles. As a result of the exclusion of these industries from the general rules, over time international markets in these sectors became very distorted and, in the case of agriculture, characterized by *beggar-thy-neighbour* subsidies. The international conflict over agricultural policies began to spill over into other areas of international trade and to taint other aspects of

international relations (Gaisford and Kerr, 2001). A general consensus was reached that agriculture and textiles needed to be brought under general GATT disciplines, and this became part of the agenda for the Uruguay Round negotiations that began in 1986.

The Uruguay Round also dealt directly with the need to expand the scope of, and otherwise reform, the GATT. In particular, developed countries wanted to have a multilateral agreement on trade in services and to provide for the international protection of intellectual property (Kerr, 2000). Neither of these issues was readily embraced by developing countries. The distortions in the international agriculture and textile markets were, however, issues where liberalization of market access to developed-country markets and reductions in subsidies were of major interest to developing countries. The elements of a new grand bargain were in place. In exchange for accepting disciplines on trade in services and agreeing to protect the intellectual property of foreign firms, developing countries would receive better market access to developed-country markets for their textiles and agricultural goods, and trade-distorting agricultural subsidies would be reduced.⁹ The successful conclusion of the Uruguay Round in 1986 brought a new institution, the World Trade Organization, a revised GATT Agreement (GATT 1994) that included a phase-out of the multifibre agreement, and an Agreement on Agriculture (AoA) plus two new agreements, the Agreement on Trade in Services (TBT) and the Agreement on Trade Related Aspects of Intellectual Property (TRIPS). The phase out of the multifibre agreement appeared to provide for access to developed-country markets for developing-country textiles, and the AoA appeared to provide for substantial tariff reductions, the removal of quantitative barriers to agricultural imports and considerable reductions in both export subsidies for agricultural goods and domestic subsidies paid to farmers in developed countries. A number of potential agreement assessment exercises using relatively sophisticated economic models conducted prior to the agreement appeared to confirm this assessment. This would have been the case if the Uruguay Round agreements had represented *search agreements*.¹⁰

In fact, the Uruguay Round and particularly the AoA were sufficiently opaque that they could be manipulated strategically by those countries that had a better understanding of the rules of trade – a clear asymmetric information problem. No sooner had developed countries obtained what they wanted from developing countries – deals on services and the protection of foreign intellectual property – than they began to take advantage of their information advantage. Effective tariff reductions for agricultural products of developing countries did not materialize, due to the ability to average tariff cuts so that reductions on less sensitive products could offset small cuts

for sensitive products and due to considerable *water in the tariffs*. The increased market access expected from the tariffication of quantitative restrictions did not materialize because no standardized methods for tariffication had been agreed, leading to *dirty tariffication*.¹¹ Export subsidies for agricultural products and domestic support for farmers in developed countries were not substantially reduced, due to the ability to average subsidies across a number of commodities, the use of periods of high subsidization as the base years for calculating subsidy reductions and, over the longer run, shifting payments from constrained subsidy categories to unconstrained categories – box shifting. As a result, the price increases expected in international markets as a result of subsidy reductions simply did not materialize.¹² In textiles, as the reforms to the quota systems of the former multifibre arrangements began to improve market access, there appeared to be a rise in the use of contingency protection measures – antidumping and countervail actions – aimed at extending protection in politically sensitive areas. None of the forecasts done prior to the agreement appear to have anticipated the potential for opportunism and, hence, treated the Uruguay Round as a set of transparent documents that could be comfortably assessed prior to implementation.

In short, rather than the AoA (and aspects of other Uruguay Round agreements) being a *search* trade agreement, for developing countries it became an *experience* trade agreement – the result could only be determined during the agreement's implementation. For developing countries, the experience was universally a bad one. From their perspective, they had simply been outsmarted by trade policy experts in developed countries able to act opportunistically on the basis of asymmetric information. The frustration of developing countries manifested itself in a number of ways. They forced issues concerning *implementation* onto the multilateral trade negotiation agenda in an attempt to salvage some of the expected benefits they had been denied. They thwarted attempts to launch a new round of negotiations until development became the focus of the new Doha Round. Developing countries demanded significant increases in funds for trade policy capacity building from the World Trade Organization and the aid agencies of developed countries. A new grouping of countries negotiating from a common position emerged, the G20, which encompassed the major developing countries led by Brazil, India and China.¹³ This group's primary aim was to guard the interests of developing countries despite what would appear to be notable divergence in their individual interests. The emergence of the G20 considerably altered the dynamics of multilateral trade negotiations.

The experience of AoA implementation can only make reaching agreement at multilateral negotiations more difficult. Clearly, if agreements cannot be taken at face

value – they have *experience* or *credence* characteristics rather than *search* characteristics – then negotiators and ultimately politicians will be more wary of agreeing. Further, any empirical analysis that could be used to bolster acceptance of an agreement will be heavily discounted. Independent assessments of a potential trade agreement's economic effects are the closest institution in function to product labelling.¹⁴

Capacity building efforts can help a lot, but in many cases individuals from developing countries selected for capacity building start at basic levels, are usually already employed – meaning that their training is of short duration and infrequent – and are isolated because no local stock of mentors exists. As a result, the building of capacity is limited in scope and depth (Kerr, 2007a). There is simply no substitute for the long-term mentoring that forms the experience of most trade negotiating teams and co-requisite trade experts in developed countries. It would seem that to increase the probability of reaching a successful conclusion in future negotiations, capacity building efforts need to be combined with a concerted effort to move the characteristics of potential agreements back to those associated with *search* activities.

The Doha Round Experience

Progress at the Doha Round of multilateral negotiations has been glacial at best. It is generally agreed that the agriculture negotiations have become the lynchpin. This is not surprising given the experience of developing countries with the Uruguay Round's AoA. Faced with having to grant what they consider a politically unpalatable degree of concessions on agriculture, officials from developed countries charged with devising first the agenda and then the modalities for the agricultural negotiations have opted for increased complexity. This strategy appears to be based on the belief that complexity creates opportunities to gain advantage by being cleverer than one's opponents. In other words, either incomplete or asymmetric information will create space to act opportunistically. It also hoped that the complexity will allow sufficient latitude for interpretation that any party can claim the eventual agreement is a triumph. Not all of the blame for the complexity of the potential modalities lies with the officials from developed countries; some developing countries also do not want to make politically unpalatable concessions on market access and, hence, have been adding to the complexity of the potential modalities pertaining to special and differential treatment.

The result of these attempts at being clever is a degree of complexity that has created sufficient permutations of potential outcomes so as to defy assessment – or

where the transaction costs associated with acquiring information on the potential outcomes are prohibitive. There is no credible means to signal quality. If one looks at the two remaining contentious pillars of the agriculture negotiations – domestic support for farmers and market access – the combined range of outcomes is staggering. In market access there are self-designated lists of sensitive and special products to be negotiated. Special products designations are only available to developing countries. The current discussions regarding the extent of these lists are being undertaken in terms of the percentage of tariff lines that they can encompass. Tariff lines are notoriously difficult to work with, to say nothing of attempting to look at the tariff lines of 140 plus trading partners as well as your own. The range of percentages of tariff lines being proposed for sensitive products is between 1 and 8 percent – a huge range. Even if a percentage of tariff lines can be agreed, countries will have to select the actual tariff lines they want to include. Further, sensitive and special products are not supposed to totally escape tariff cuts; the intention is only that the tariff cuts will be less than those applied to products not put on the lists. Any quantitative evaluations of the impact of sensitive and special products can be only crude approximations at best.

For products not on the sensitive and special products list there will be a number of bands (tiers) based on the size of existing bound tariffs, with tariffs within the differing bands having different schedules of reduction. Bands with higher tariffs will have larger cuts. The number of the bands, the boundaries of the bands, the amounts of the reductions for tariffs in each band and the time schedule and trajectory for the reductions have all been open for negotiation. *Ex ante* assessment of the multiple permutations is clearly a resource-intensive exercise. Further, until the parameters for the lists of sensitive and special products are known, the tariff lines (particularly in the upper bands) cannot be known. In addition, the tariff reductions for developing countries are to be less than those for developed countries, and the number and boundaries of bands that will apply to developing countries' tariffs might also differ from those of developed countries.¹⁵ A special safeguard for developing countries' agricultural imports has been agreed but its operation is still the subject of negotiation. Then there is the issue of reform of TRQs, etc., etc., etc.

In the case of domestic support for farmers, three separate areas are under discussion. There are to be reductions to actionable (amber-box) subsidies through reductions to the Aggregate Measure of Support (AMS), which is the Uruguay Round cap on actionable subsidies. The currently uncapped blue-box subsidies will be capped at 5 percent of the value of historic production but the types of subsidies allowed in the box will likely be expanded (Rude and Meilke, 2006). The AMS was

calculated based on all support levels in a base period that were greater than a *de minimis* level of 5 percent of the value of production, either for individual products or for more broadly based programs. The currently proposed modalities would see *de minimis* reduced from 5 percent. Further, the Doha agenda for agriculture would see a total cap on the sum of AMS, blue-box subsidies and the *de minimis* exemptions. As with market access, the combinations are numerous and evaluation is complex. Brink (2006) provides an example of how complicated it is to assess these proposals for the United States and the EU alone. Further, countries will be able to individually juggle how their subsidies will be paid to minimise the effect. Governments will also have the choice to alter the way subsidies are paid so that they can be considered allowable – green-box – subsidies. Thus, the actual degree of subsidy reduction cannot be determined *ex ante*. Beyond the limits on all of the subsidy categories having yet to be determined, time schedules for reductions – both the total time and the trajectory of reductions – will have to be negotiated.

Given this degree of complexity, if an agreement is actually arrived at, assessment will probably not be possible even after implementation – in other words the agreement can be characterized as being *credence* rather than *experience*. This will certainly be true in the case of many developing countries whose capacities to undertake assessments are limited. One suspects, however, that even for the most technically capable countries the cost of undertaking a credible assessment will be prohibitively expensive. Certainly, attempts at *ex ante* independent assessments are being made, but I detect little enthusiasm for such exercises, and the economists producing the assessments are careful to stress the degree of uncertainty that surrounds their results.

The *credence* characteristics of the current agenda and proposed modalities in the agriculture negotiations make decision makers wary. If there is no way to tell whether it is a bad agreement, the predilection is likely not to agree. Uncertainty also makes negotiators cautious, meaning they will not wish to move far from their “safe harbour” initial negotiating positions designed to ensure that a deal won’t be a *bad* deal from their perspective. This reluctance, of course, makes it much more difficult to find the necessary middle ground compromises. Positions remain polarized.

Without clear evidence that the potential deal is a *good* deal, it is difficult for politicians to promote the potential agreement and to find private sector actors to push for a deal. The complexity puts the entire negotiations at risk. Given the consensus-based decision making mechanism of the WTO, *credence* is a recipe for failure.

One of the other central tenets of Transaction Cost Economics is *bounded rationality* (Simon, 1957). Bounded rationality moves away from the neoclassical

assumption that decision making is a costless activity taken under conditions of perfect information. Under bounded rationality, individuals are expected to make rational choices based on the information that is available and subject to their ability to process that information. In my own experience with capacity building in developing countries, for example, I consistently watch participants tune out, turn off and otherwise disengage when I try to explain even the rudiments of the proposed modalities for domestic support for farmers – amber box, AMS, blue box, caps, *de minimis* reductions, caps on the total – even when they have some understanding of each of the concepts.¹⁶ They are not processing the information and if ever faced with making a decision or recommendation on a proposal on domestic support, they would likely reject it. Of course, some participants do remain engaged, and at the end of my discussion on domestic support one of the participants will inevitably ask, “So what does it mean for my country?” I am forced to answer honestly, “I haven’t a clue.” The frustrated response from the participant is typically, “I can’t take that to my minister/boss.” I then usually respond by asking: “If you were to be asked by your minister/boss about a proposal on domestic support, what would you say?” The reply: “The safe option for us is rejection of the proposal” – *bounded rationality*.

It is probably not possible to fully comprehend the mind-numbing complexity that has been built into the current negotiations on agriculture without reading some of the material provided by the WTO. A good place to start might be the communications of the chairman of the Doha Round agriculture negotiations, Crawford Falconer, released on April 30 and May 25, 2007 (Falconer, 2007a; Falconer, 2007b). The reason for the two communications was to try to provide clarification as to how the negotiations on agriculture could be moved forward. The two documents contain 230 paragraphs of text of varying length – and remember this is only the agriculture negotiations. The complexity of these *challenge* documents can only be appreciated by reading them.¹⁷ One passage will serve to illustrate the problem. Paragraph 132 of the April 30 document (Falconer, 2007a) addresses the self-designation process for special products – one might think this could be a relatively straight forward issue. Special products can be designated if they can be justified on the basis of the broad criteria of promoting food security, rural development or livelihood security. The passage states:

Hong Kong clarifies that self-designation is to be *guided* by indicators, and that those indicators are to be *based on* the criteria. If something (in this case “indicators”) is a guide, it must be capable of telling you where to go: it has to be able to describe a path. To be a guide worthy of the name it must be intelligible and accessible to the reader. It has to be transparent. Which means, operationally, it has to be objectively and intrinsically intelligible: it is the *indicator itself* that is providing the guidance, so it would fail to do that if there was a need for some kind of supplementary

interpretation to be additionally required from elsewhere. Something describing itself as a guidebook would get consigned to the dustbin if, upon opening it, you were told: the writer knows how to get around Geneva but he hasn't got a map to give you – suggest you go and ask a cab driver if you can find one. In this case we are also to have a particular *kind* of guide: it is to be *based* on criteria. If something is “based” on something it has to be grounded in it: it has a relationship of dependency. It doesn't just have a “vague relationship” or “connection” or a “loose association”. It has to be capable of exhibiting a discernable rationale. Or taking this together and putting it more prosaically: these “indicators”, to be worthy of the name would have to transparently, objectively and intelligibly exhibit their rationale.

It is not surprising that Ambassador Falconer longs for a return to less complexity – see the quote that started this paper. While some aspects of trade agreements are inherently complex (e.g., sanitary and phytosanitary measures), tariffs and subsidies need not be. One can be too clever. For many countries, to opt for no agreement would be the rational decision. This is in spite of the damage that not reaching agreement would do to the reputation and efficacy of the multilateral system. Trade agreements are too important to be defined by credence characteristics.

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Endnotes

1. See Falconer (2007a), paragraph 145.
2. See North (1987) and North and Thomas (1973) for examples where New Institutional Economics is used to explain economic development and the rise of modern market economies. Kerr and MacKay (1997) use it to garner insights into economies in transition from command to market-led economies.
3. Kerr (1997) uses New Institutional Economics to examine aspects of the North American Free Trade Agreement.
4. While the threat of trade retaliation may have, in some cases, deterred the granting of protection to vested interests, it did not alter the form of the measure used to provide protection.
5. Although there are early examples of the abuse of sanitary and phytosanitary measures to provide protection. According to the official website of the Office International des Epizootics (OIE), in 1924 "... the Economic Committee of the League of Nations thus proposed to facilitate international trade in animals and animal products to try and reverse the *often highly overt tendency of numerous countries to use sanitary arguments purely for the purpose of economic protection*" (emphasis added) (OIE, 2000). The OIE was established in an attempt to deal with this issue by increasing transparency through the provision of international standards. A problem of information asymmetry arises when the imposer of the sanitary barrier knows whether or not the barrier is being imposed for legitimate reasons while the party facing the sanitary barrier cannot be sure if the barrier is legitimate. International standards provide legitimacy for both those imposing the barrier and those facing the barrier.
6. The United Nations to deal with political conflicts, the International Monetary Fund to deal with the conflicts arising from strategic devaluations of currencies, the World Bank to mitigate the potential for conflict arising from differing levels of development and the International Trade Organization to deal with conflicts over trade policy.
7. In the U.S. constitution, the Administrative branch negotiates international trade agreements but the Congress must ratify them. Given the economic hegemony of the United States in the late 1940s there was no use having the International Trade Organization without U.S. participation, and it was abandoned internationally.
8. See Miner (2007) for a discussion of the expanding role of the GATT.

9. Of course, there were some additional *grand bargains* among developed countries, particularly the EU and the United States.
10. Kerr (2002) argues that this was the first time that developing countries had been seriously engaged in the negotiations and that there was something on offer that they actually wanted. Hence, even if many developing countries had been at the negotiating table previously, they actually had had little capacity to assess the economic potential of proposed agreements *ex ante*.
11. As a result, quantitative restrictions were converted into tariffs at such high rates that little or no market access resulted. Dirty tariffication also led to very high over-quota tariffs in the new tariff-rate quotas (TRQs) that had been created for some agricultural commodities.
12. Gaisford and Kerr (2001) argue that in the long run all forms of subsidies are trade distorting and, hence, that the focus on decoupled subsidies is short run and little can be expected from decoupling.
13. See Jank and Jales (2005) for a discussion of the role of the G20.
14. The role of independent assessments is crucial for complex agreements – they signal quality. These assessments have a transaction cost-reducing role in the case of *search* agreements, but the role is not essential. Assessments that could anticipate opportunistic behaviour could turn what would be an *experience* agreement into a *search* agreement. This was not the case for the Uruguay Round and, as a result, the credibility of independent assessments has been considerably eroded.
15. This particular issue may have been solved, as long as the negotiations move forward from what is already agreed; however, given that deadlines have been missed and negotiations, at times, suspended, the possibility of withdrawing already agreed modalities cannot be ruled out.
16. Of course, one might argue that this is simply the result of my presentation. I can only note that I find that participants remain engaged over a wide variety of other trade topics I present. Further, despite my trying a number of different methods of presentation the resulting disengagement is the same.
17. This is not meant to be a criticism of Ambassador Falconer's writing style; I simply think he has an impossible job given the complexity with which the negotiations have already been infused.