

Hudson Institute

The Importance of WTO Reform from a Transatlantic Perspective

*Thomas J. Duesterberg, Ph.D.
Senior Fellow*

February 2019



Hudson Institute

The Importance of WTO Reform from a Transatlantic Perspective

Thomas J. Duesterberg, Ph.D.
Senior Fellow



© 2019 Hudson Institute, Inc. All rights reserved.

For more information about obtaining additional copies of this or other Hudson Institute publications, please visit Hudson's website, www.hudson.org

Hudson Institute is grateful for the support of the Konrad-Adenauer-Stiftung in funding the research and completion of this report.

ABOUT HUDSON INSTITUTE

Hudson Institute is a research organization promoting American leadership and global engagement for a secure, free, and prosperous future.

Founded in 1961 by strategist Herman Kahn, Hudson Institute challenges conventional thinking and helps manage strategic transitions to the future through interdisciplinary studies in defense, international relations, economics, health care, technology, culture, and law.

Hudson seeks to guide public policy makers and global leaders in government and business through a vigorous program of publications, conferences, policy briefings and recommendations.

Visit **www.hudson.org** for more information.

Hudson Institute

1201 Pennsylvania Avenue, N.W.
Suite 400
Washington, D.C. 20004

P: 202.974.2400
info@hudson.org
www.hudson.org

EXECUTIVE SUMMARY

Trade is at the forefront of international tensions in 2019. Political developments in the United States and Europe, and the rise of China as a peer competitor to the transatlantic economies, have led many to question the fundamental assumptions and operations supporting the World Trade Organization (WTO). Chinese mercantilism, the Trump administration's aggressive use of unilateral tariff measures, and the inability of WTO members to reach consensus on expanding its disciplines to important new sectors and forms of commerce in the modern economy reinforce the critique of the WTO. Expansion in global trade, one of the great engines of growth and progress in bringing billions of people out of poverty since 1945, has slowed considerably in the last two decades. In 2018, however, several constructive efforts to craft reforms for this successor institution of the Bretton Woods system are engendering some hope that the WTO can be adapted to meet the needs of the contemporary economy.

The first basket of problems revolves around a lack of WTO disciplines for newer sectors like services, including those associated with the emerging digital economy; for state-owned enterprises; for intellectual property protection; and for cross-border investments. The other main issues concern the sometimes ineffective and bounded operations of the WTO itself. Questions have been raised, notably by the United States, over the slow and inconsistent enforcement of existing WTO rules, and over rulings by judges in the Appellate Body which overstep the limits of existing WTO rules, undertake interpretations of domestic laws, and reinterpret facts established by earlier dispute panel decisions. This is the biggest issue now dividing US and EU thinking on the reform of the WTO.

The EU, Canada, Japan, the United States and other members have begun offering concrete proposals for addressing these problems, and the G20 political leaders gave a strong endorsement to their efforts in the December 2018 communique of the Buenos Aires summit. Ideas for new rules are being tested in sub-global trade agreements like the new North American and Trans-Pacific pacts and EU free trade agreements with Canada and Japan. Incorporation of new rules into the global WTO is extremely difficult; full consensus among its 164 members is required for the adoption of any new disciplines or internal operations. To overcome that impediment, this paper suggests that plurilateral agreements, like the Information Technology Agreement of 1997, be employed to establish and test new rules needed for the 21st-century economy. Some use of supermajority decision making instead of the consensus rule may also help advance the creation of new rules and redress weaknesses in WTO operations. The role of transatlantic leadership, finally, is emphasized as a key to building broad political support needed to achieve substantive reform.

BACKGROUND

The year 2018 witnessed an encouraging trend toward cooperation in transatlantic trade relations. After a rocky start to the Trump administration in 2017 because of the imposition of tariffs on solar panels, steel and aluminum, and its repeated threats of auto tariffs, the Trump-Juncker meeting in July resulted in a truce in the tariff war and the promise of negotiations to address longstanding disputes and grievances in transatlantic trade. An equally important development arose from the December 2017 World Trade Organization (WTO) ministerial conference (the so-called MC11) in Buenos Aires, where trade ministers for the United States, the European Union (EU), and Japan initiated a process to develop common approaches to reform the organization. The group met at the ministerial level at least three times in 2018 to map out the reform agenda.¹ Additionally, at the Buenos Aires ministerial, 70 member nations agreed to “initiate exploratory work toward future WTO negotiations in trade-related aspects of electronic commerce.”² These dialogues are signs that the major players in the WTO take very seriously the need to update the rules and procedures of the institution. Along with Japan, the transatlantic partners are taking a leadership role in the effort. Nonetheless, significant obstacles to transatlantic agreement about certain major areas of WTO reform remain.

Keeping Pace with the 21st Century Economy. There are several fundamental reasons for urgency about finding common ground on updating and improving the scope and functioning of the WTO, which was established in 1995. Most importantly, the organization has simply not kept up with the pace of change in the 21st-century economy. The most obvious example involves new issues resulting from the rapid growth of digital commerce, an industry that barely existed in 1995 but is now raising broad concerns—as demonstrated by the 70-nation agreement at the MC11 conference in Buenos Aires—over the need for effective trade and investment rules. Specific problems are related to the flows of data across national borders, the enforcement of data localization rules in certain major economies like China, and national treatment of providers exporting their products and services.³ The growing need to place digital commerce under a multilateral, rules-based system also directly underscores the current functional imperfection of the WTO. WTO negotiations expanding coverage of trade in services have languished for years. This sector is linked closely to trade in goods and has become more and more dominant in the globalized economy.⁴

¹ See for example, Office of the US Trade Representative, “Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan and the European Union” (May 31, 2018), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/may/joint-statement-trilateral-meeting>

² See International Centre for Trade and Sustainable Development (ICTSD), “Updating the Multilateral Rule Book on E-Commerce” (ICTSD, Policy Brief, March 2018). https://search.yahoo.com/search?p=updating+the+multilateral+rule+book+on+e-commerce&fr=yset_widemail_chr_win&type=default

³ *Ibid.*, p. 2.

⁴ See International Monetary Fund, the World Bank and World Trade Organization, “Reinvigorating Trade and Inclusive Growth” (Washington: World Bank, 2018). pp. 9-14, <https://www.worldbank.org/en/topic/trade/publication/reinvigorating-trade-and-inclusive-growth>

Another major gap in WTO rules receiving increased scrutiny involves the resurgence of state-owned enterprises (SOEs) in many large economies. Despite the collapse nearly 30 years ago of state-dominated communist economies, including the transition in China to a more market-oriented regime, SOEs have displayed a remarkable resilience and even renewed growth in the 21st century. In 2013, 81 percent of revenues in Russia's top ten firms came from SOEs. The numbers for Brazil were 50 percent, for the United Arab Emirates 88 percent, for India 59 percent, and for France 17 percent.⁵ The impact of SOEs in global markets can be seen, among many examples, in the commercial aviation industry, where state-dominated and financed carriers in the Middle East, Turkey, China, and elsewhere are undermining the business models of airline companies in market dominated countries like the United States, Europe, and Australia.⁶ China features some of the most well-funded and globally aggressive SOEs, and their role has been reinforced under the leadership of Xi Jinping. Eight of the ten largest Chinese firms in 2017 were SOEs.⁷ It is often difficult to differentiate SOEs from private, market-oriented firms in China due to opaque ownership networks and creative use of subsidies and market restrictions favoring these firms by central, regional, and local governments. WTO rules fail to reach most mercantilist and non-market practices of SOEs and are badly in need of updating.

The joint statement from the September 2018 trilateral meeting of the US, EU, and Japanese trade ministers details some of the *lacunae* in WTO rules covering the trade distorting impacts of SOEs, and clearly suggests that Chinese firms are at the center of those concerns:⁸

The Ministers highlighted the importance of securing a level playing field given the challenges posed by third parties developing State-Owned Enterprises into national champions and setting them loose in global markets.... The Ministers recognized ... the need ... to develop effective rules to address market-distorting behavior of state enterprises and confront particularly harmful subsidy practices such as state-owned bank lending incompatible with a company's credit worthiness ... or government-controlled investment fund equity investments on non-commercial terms ... preferring input pricing ... and subsidies leading to or maintaining overcapacity.

The ministerial statement also references other concerns that existing WTO rules cannot adequately address. These include forced technology transfer, cybertheft of intellectual property, and manipulation of rules on developed and developing country status for national advantage.

⁵ See M. Buge, M. Egeland, P. Kowalski, and M. Szajerowska, "State-Owned Enterprises in the Global Economy: Reason for Concern?" (Washington: Center for Economic and Policy Research, May, 2013), <https://voxeu.org/article/state-owned-enterprises-global-economy-reason-concern>

⁶ See Thomas J. Duesterberg, "Subsidies and Unfair Competition in Global Commercial Aviation: How to Respond." (Washington: Hudson Institute, 2018). <https://www.hudson.org/research/14641-subsidies-and-unfair-competition-in-global-commercial-aviation-how-to-respond>

⁷ China Banking News, "Top Ranks of China's Fortune 500 Still Dominated by State-Owned Enterprises," August 1, 2017. <http://www.chinabankingnews.com/2017/08/01/top-ranks-chinas-fortune-500-still-dominated-state-owned-enterprises/>

⁸ Office of the US Trade Representative, "Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan and the European Union," September 2018, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/september/joint-statement-trilateral>

Problems with the Internal Workings of the WTO. The second major basket of problems behind the effort to reform the WTO concerns the processes, procedures, and efficiency of the existing organization. The United States has notably developed a critique of the dispute settlement mechanisms of the WTO, especially with the Appellate Body (AB).⁹ It has questioned or blocked appointments of new members to the AB, starting with the second Bush and Obama administrations, because of perceived problems with the decision making and timeliness of appeals rulings. Important elements of the US critique include: the AB's inability to issue timely reports, overreach of AB decisions which then set policy for the WTO without input from the full membership, AB issuance of decisions on the facts of a case (which should be handled by the first step of the dispute settlement process, much like the relation in the United States between a circuit court and a court of appeals), and rulings that interpret domestic laws, which are beyond the AB's statutory remit.¹⁰

Although the United States has been bitterly criticized for its stance on reform, especially regarding the work of the AB, which could be brought to a halt as soon as late 2019 due to lack of judges, other important participants have recently recognized some frailties in the functioning of the WTO and have started to offer constructive solutions. WTO Director General Azevedo has admitted that “the system is in dire need of improvements and updates.”¹¹ The EU, joined by 11 other WTO member states, has tabled specific ideas for WTO reform, including some that directly address the US critique of the AB.¹² Canada has also advanced constructive ideas for fixing problems with WTO rules and enforcement, and convened a group of a dozen member countries in Ottawa in October to discuss its approach to reform.¹³

Slowing Growth in World Trade and the Need for Liberalization of Services. The third substantial argument for taking on the difficult task of WTO reform is that the stagnation, inefficiency, and lack of coverage of WTO rules in new areas is having a negative effect on global growth. The expansion of cross border trade averaged about seven percent annually in the relatively peaceful 1990s.¹⁴ The unexpectedly benign dissolution of the Soviet bloc and increasing integration of East Asian countries and India into the rules-based trading system helped spur expansion in trade and unprecedented growth in per capita Gross Domestic Product (GDP) in the period. But in the 2000s trade growth slowed substantially, due both to non-cyclical factors and to complete lack of

⁹ See Office of the US Trade Representative, “2018 Trade Policy Agenda and 2017 Annual Report” (Washington: Office of the US Trade Representative, 2018), especially Chapter II for a summary of the US critique, <https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2018/2018-trade-policy-agenda-and-2017>

¹⁰ For a good summary of the issues see: T. Payosova, G. Hufbauer, and J. Schott: “The Dispute Settlement Crisis in the World Trade Organization: Causes and Cures” (Washington: Peterson Institute for International Economics, 2018). Policy Brief No. 18-5. https://search.yahoo.com/search?p=the+disputes+settlement+crisis+in+the+world+trade+organization+causes+and+cures&fr=yset_widemail_chr_win&type=default

¹¹ See Politico Morning Trade, October 24, 2018, “Azevedo Looks for Creativity in Ottawa,” www.politico.com/newsletters/morning-trade/2018/10/24/azevedo-looks-for-creativity-in-ottawa

¹² See World Trade Organization, “Communication from the European Union, China, Canada, et al.,” WTO General Council, Nov. 28, 2018, WT/GC/W/752-3.

¹³ Ibid.

¹⁴ “Reinvigorating Trade and Inclusive Growth,” op. cit. (note 4), p. 7.

progress in expanding WTO rules to new areas. The Bretton Woods institutions argue that “certain ‘frontier’ areas of trade policy have high potential to lift global productivity and durably increase medium-term growth.”¹⁵ Notable among these frontier areas are advanced services, including digital services. This sector is increasingly linked to the production, distribution, and constant improvement in the sophistication and connectivity of goods and supply chains. “Manufacturers’ access to better, more reliable and more diverse business services enhanced firms’ ability to invest in new opportunities and technologies to concentrate production in fewer locations, to efficiently manage inventories, and to coordinate decisions with suppliers and customers.” One study cited by the World Bank estimates that full services trade liberalization could raise manufacturing productivity by an average of 22 percent.¹⁶

Liberalization of financial services trade could of course benefit both large and small companies by introducing more competition and choice. A special role for digital services liberalization and disciplines from globally agreed rules is likely to be of substantial benefit to small and medium sized firms, in both developed and developing countries. Digital banking services would especially benefit small firms in developing countries like India and Indonesia. A recent study by Deloitte outlined the costs and opportunities of adopting rules (such as those enshrined in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership or CPTPP) to deter data localization requirements and limitations on cross-border data flows. According to the Deloitte analysis, these limits:¹⁷

- prevent broad choices and competition for businesses and consumers;
- restrict access to business opportunities arising from online access and accumulation of customer data;
- limit businesses from the advantages of synthesizing large data sets;
- raise costs by requiring duplicative and sub-optimal scale of data storage facilities; and
- increase security risks by requiring multiple entry points for global platforms.

These problems are exceptionally acute for small and medium sized enterprises, including those in the United States and Europe, which are often late to export markets in any case.

In addition to the drag on global economic performance due to lack of WTO rules covering new services areas and subsidized SOEs, I outlined earlier this year many of the more direct costs to advanced transatlantic economies resulting from mercantilist practices and failure to follow existing WTO rules by Chinese companies and government controlled or owned enterprises.¹⁸ One salient current example of the threat is from the

¹⁵ Ibid., pp. 8-11

¹⁶ Ibid., p. 10.

¹⁷ Deloitte, “Advancing the ASEAN Economic Community: The Digital Economy and the Free Flow of Data” (Washington: US-ASEAN Business Council, 2016), p. 18.

¹⁸ Thomas J. Duesterberg, “Chinese Economic and Trade Challenges to the West: Prospects and Consequences from a U. S.-German Perspective” (Washington: Hudson Institute, 2018),

auto sector. Although German and US automobiles have enjoyed some success in China, how much more could they prosper if there were symmetric opportunities in that vast auto market, the world's largest? The list of barriers to foreign automakers is a long one: 25 percent import tariffs versus 2.5 for the United States (before the imposition of new tariffs by President Trump in 2018) and 10 percent for European imports; requirements to have joint ventures (JVs) for any foreign production in China, and the concomitant demand to share all technology used in Chinese JV production; large tax credits (\$7500) for electric vehicles sold into the United States by Chinese (and all other foreign makers exporting to the US), while China gives a \$10,000 subsidy to such vehicles produced in China but denies it for all imports; and competition in China from state-owned and financed firms.¹⁹ The leading US automaker, General Motors, recently announced the closure of domestic production facilities and reduction in its labor force by 15,000 workers.²⁰

General Motors is the leading electric vehicle producer in the United States. Automobile production is the largest economic driver of the German economy.²¹ Aggressive Chinese support for electric vehicle production under the “Made in China 2025” program is a direct threat to the economic vitality of both the United States and Germany. Similar arguments could be made about other major industrial sector targets: robotics, semiconductors, construction equipment, machine tools, and commercial aviation are all targeted by the China 2025 program. New areas not well covered by WTO rules, like cross border data flows—which will be crucial to the development of the Internet of Things (IOT), Artificial Intelligence (AI), and self-driving vehicles—also will affect transatlantic leadership in the technology sector. The battle over 5G communications technology, finally, is important not only to technology leadership but to national security as well.²² None of these areas is well covered by WTO rules and enforcement mechanisms.

Strengthening Transatlantic Cooperation. The final compelling reason to undertake the daunting task of WTO reform is that success could help blunt the hard edges of Trump trade policies while at the same time reinforcing the effort to reduce US-EU tensions over trade. Transatlantic cooperation is certainly necessary with respect to China; acting alone, neither the United States nor Europe is likely to succeed in reining in the mercantilist practices of such an enormous and determined economic power.²³ The transatlantic partners have similarly structured economies and share vulnerabilities to the Chinese challenge. Moreover, the United States and Europe have long been pillars of

<https://www.hudson.org/research/14150-chinese-economic-and-trade-challenges-to-the-west-prospects-and-consequences-from-a-u-s-german-perspective>

¹⁹ See Irwin Stelzer, “Trump is Right: Five Ways Chinese Car Makers are Hosing America,” *The Weekly Standard*, Nov. 21, 2017.

²⁰ Ian Thibodeau, “End of the Line for Impala, Volt, Cruze, LaCrosse,” *Detroit News*, Nov. 26, 2018.

²¹ “Chinese Economic and Trade Challenges,” op. cit. (Note 18), p. 10.

²² Thomas J. Duesterberg, “China’s Dream to Dominate World Technology,” *The Globalist*, Dec. 19, 2017, <https://www.theglobalist.com/china-united-states-europe-technology-internet/>. See also Arthur Herman, “Huawei’s (and China’s) Dangerous High-Tech Game,” *Forbes*, December 10, 2018, <https://www.forbes.com/sites/arthurherman/2018/12/10/huaweis-and-chinas-dangerous-high-tech-game/#62babb2011ab>

²³ Thomas J. Duesterberg, “Trump Needs Allies on Trade,” *Wall Street Journal*, April 24, 2018, <https://www.wsj.com/articles/trump-needs-allies-on-trade-1524524224>

what has become the rules-based trade order, and their cooperation is vital to its continued success. In a recent study commissioned by the European Parliament, German Marshall Fund scholars made the case for such cooperation as part of the EU's overall strategy to respond to the Trump administration's trade challenge:²⁴

A possible key to turning the debate with the Administration ... might start with accepting this need for a 'rebalancing' as a basis—and responsibility—for the European Union ... as well as Japan and others, including China. Done properly, this would shift the debate away from acting only in response to threats emanating from Washington and could very well address a number of issues that are separate priorities, again including China. Three areas in particular stand out as fields for such a more positive, constructive engagement—bilateral trade relations, the WTO, and China.

WTO reform, then, captures the major priorities of the EU and the United States in the trade arena, with a focus on China, and is complementary to the Trump-Juncker dialogue.

REFORM PRIORITIES

Fixing WTO Operations: The Biggest Challenge. The near-term objective for WTO reform and modernization is improving the operational efficiency and effectiveness of the organization. Many members have already advanced constructive ideas for addressing the weaknesses and over-reaching that have been outlined in the first part of this paper. While broad differences among parties remain, there is considerable momentum for action coming from the trilateral dialogue and, most recently, from the agreed communique of the Buenos Aires G20 meeting.²⁵ Even though many nations have expressed frustration with the insistence of the United States on blocking new AB appointments as a negotiating tactic, United States Trade Representative (USTR) Robert Lighthizer gave a robust endorsement to the overall reform effort following the December 2017 WTO ministerial meeting:²⁶

MC11 will be remembered as the moment when the impasse at the WTO was broken. Many members recognized that the WTO must pursue a fresh start in key areas so that like-minded WTO members ... are not held back by the few members not ready to act... We welcome the opportunity in 2018 to continue to discuss how we can improve the functioning of the WTO.

In the next section I will discuss the implication of Lighthizer's reference to work by "like-minded members." In this section I outline the principle issues that need to be covered by the reform effort to achieve its economic and political objectives.

²⁴ Peter Chase, Peter Sparding, and Yuki Mukai, "Consequences of US Trade Policy in EU-US Relations and the Global Trading System," a study requested by the INTA Committee (Brussels, European Parliament Think Tank, 2018). p. 42, [http://www.europarl.europa.eu/thinktank/en/document.html?reference=EXPO_STU\(2018\)603882](http://www.europarl.europa.eu/thinktank/en/document.html?reference=EXPO_STU(2018)603882)

²⁵ Scott Squires and Caroline Stauffer, "G20 Nations Agree on Reforming WTO: European Officials," *Reuters*, December 1, 2018, <https://www.reuters.com/article/us-g20-argentina-communique/g20-nations-agree-on-reforming-wto-european-officials-idUSKCN1O03AA>

²⁶ Office of the USTR, "USTR Robert Lighthizer Statement on the Conclusion of the WTO Ministerial Conference," December, 2017, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/december/ustr-robert-lighthizer-statement>

In the first place the WTO and its membership need to better enforce existing rules. Much has been made of the difficulty of interpreting and enforcing existing rules on intellectual property rights (IPR), and new rules must be crafted to cover contemporary practices by China and others. Nevertheless, the United States did initiate a case at the WTO in March 2018 after a report undertaken unilaterally under section 301 of the Trade Act of 1974.²⁷ The EU later filed a similar case at the WTO.²⁸ These cases will require considerable time to adjudicate, but they do show determination from transatlantic partners (joined by Australia, Japan, and others) to enforce existing rules. Relying on enforcement to a greater extent would show confidence in the WTO.

There has been less success in enforcing the WTO's transparency requirements covering state subsidies, especially those flowing to SOEs. China is famously wayward about its WTO obligations to make timely notification of state subsidies, in any form, to other member nations. As noted earlier, China provides support and subsidies at the central, regional, and local government levels. And a complex system of interlocking ownership structures in China means that many self-identified "private" firms receive hidden government support as well. If Chinese authorities do bother to report their subsidies to the WTO as required, the notices can be as many as ten years late.²⁹ The EU has offered some useful ideas about improving transparency in a white paper on WTO reform.³⁰ One idea is to allow member states to "counter-notify" a suspected subsidy in China (or any other member state), and to assume that the alleged subsidy is harmful unless compelling evidence by the accused party is provided.

The more difficult issues revolve around the US critique of the dispute settlement system, especially the work of the AB. Ambassador Lighthizer has raised questions about the AB for more than two decades, and the second Bush and Obama administrations also signaled dissatisfaction with the dispute settlement process.³¹ As noted earlier, the EU, Canada, and nine other nations have advanced substantive proposals to address the principal US concerns.³² Their statement is similar in some ways to those of trade scholars at the Peterson Institute for International Economics in Washington.³³ For instance, the long-standing US concern that AB panels have been interpreting the domestic laws of

²⁷ Office of the USTR, "Following President Trump's Section 301 Decisions, USTR Launches New WTO Challenge Against China," March, 2018, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/march/following-president-trump%E2%80%99s-section>

²⁸ Intellectual Property Watch, "EU Files WTO Case Against China over IP Rights Protection," June 6, 2018, <http://www.ip-watch.org/2018/06/06/eu-files-wto-case-china-ip-rights-protection/>

²⁹ See Sherman Katz, "Why the WTO Should Constrain the Power of China's State-Owned Enterprises," *Harvard Business Review*, December 11, 2017, <https://hbr.org/2017/12/why-the-wto-should-constrain-the-power-of-chinas-state-owned-enterprises>

³⁰ Council of the European Union, General Secretariat, "WTO Modernisation: Introduction to Future EU Proposals," Brussels, European Commission, July 5, 2018, https://search.yahoo.com/search?p=wtomodernisation%3A+introduction+to+future+eu+proposals&fr=yset_widemail_chr_win&type=default

³¹ A good, succinct summary of the US position can be found in: "Statements by the United States at the Meeting of the WTO Dispute Settlement Body," Geneva, October 29, 2018. <https://geneva.usmission.gov/2018/10/30/statements-by-the-united-states-at-the-october-29-2018-dsb-meeting/>

³² See especially the EU Statement Scheduled for Discussion at the WTO, December 12-13, 2018, General Council Meeting of the WTO, "Communication from the European Union," op. cit.

³³ "Dispute Settlement Crisis," op. cit. (Note 4).

disputants, rather than treating them as facts not subject to review in the appellate process, appears to be covered in the EU-led group's proposal to the WTO.³⁴ Unfortunately, Dennis Shea, the US Ambassador to the WTO, indicated that the EU proposal does not go far enough in limiting the ability of AB panelists to make new rules or creatively interpret existing ones. Shea admitted that the EU paper did acknowledge "to some extent" the US position, but a good deal more work will be required to bridge remaining differences.³⁵

In fact, the US position on the AB, which has been articulated over the last 20 years, and strongly reiterated by the Trump administration, is still far apart from that of the EU and Canada-led group in several key areas. Most important is the US assertion that, in essence, AB panels are making new, binding WTO law without adequate discussion and consent by member parties. This is done, according to the US position, through decision language itself and often through "advisory opinions," and by treating AB decisions as settled law which is not normally subject to review by the WTO Council or the full Dispute Settlement Body (DSB). AB decisions can be challenged and overturned by consensus of the DSB. Since consensus, generally defined as unanimity, is virtually impossible to reach in the WTO, much less in settling specific disputes, this all but assures that AB decisions, including advisory opinions which reach beyond the narrow bounds of a specific dispute, are treated as settled rules that cannot be revisited. This practice is reinforced by the acceptance of what is legally called *stare decisis*.³⁶ Drawing on strong and long-standing US tradition, USTR Lighthizer objects to the devolution of power in the WTO to the AB.

The recommended changes to WTO rules for the AB process by the EU and Canada-led group fall short of addressing the US concerns. Lengthening the terms of AB members and allowing them to serve beyond their normal terms when a replacement has not been agreed or when their term ends before a case is completed—while maintaining the *stare decisis* status of their rulings—serves to enhance their independence.³⁷ The language suggested by this group to limit advisory opinions and the making of new law, while addressing the problems expressed by the US, does not decisively prohibit such rulemaking and, according to Ambassador Shea, "instead appear[s] to endorse changing the rules to accommodate and authorize the very approaches that have given rise to Members' concerns."³⁸

A better approach has been suggested by scholars at the Peterson Institute for International Economics. The highly experienced authors argue that in cases of ambiguity or legal uncertainty, AB panels should refer the matters to the appropriate WTO committees (or the General Council) for discussion and negotiations among the members.

³⁴ "Communication from the European Union, Canada, et. al, to the General Council," Geneva, December 11, 2018. https://www.wto.org/english/news_e/news18_e/sum_gc_dec18_e.htm. See item 6.

³⁵ See Tom Miles, "Update 1-U.S. Not Swayed by WTO Reform Proposals," CNBC, December 12, 2018. <https://www.cnbc.com/2018/12/12/reuters-america-update-1-u-s-not-swayed-by-wto-reform-proposals.html>

³⁶ A good summary of the US position is: "Dispute Settlement Crisis," *op. cit.* (Note 4), pp. 4-9.

³⁷ US Ambassador to the WTO Dennis Shea argued that the EU-India-China gloss on the appointment of AB members, submitted in conjunction with the larger EU group's proposals, would render the AB "even less accountable and more susceptible to overreaching." See "Statement by the United States at the Meeting of the WTO General Council," Geneva, December 12, 2018, especially item 7 https://www.wto.org/english/news_e/news18_e/sum_gc_dec18_e.htm

³⁸ *Ibid.*

That is, they argue for retaining the original structure of the WTO, a position exhaustively reviewed and documented by Ambassador Shea,³⁹ keeping what amounts to legislative power in the general membership and limiting AB panels to applying the law to individual cases. A European think tank, the Jacques Delors Institute, suggests a similar approach:⁴⁰

Rather than contesting the supranationality of the AB's decisions, a first possibility to clarify the 'constructive ambiguity' of the WTO rules would be to refer to a WTO Committee the ambiguous issues that require debate and negotiations between members—this is the option preferred by Washington.

Both research institutes explore a fallback position, which would defer to WTO Committees but jettison the unanimity principle in favor of decisions by a supermajority of members, generally defined as three-fourths of the membership. Since some of the contested and yet to be settled issues are vitally important economically and politically—zeroing out on antidumping duties, market status for China, and treatment of subsidies for SOEs, for example—such a reversion may not prove acceptable to large WTO economies.

Another possibility suggested by European sources is called the “nuclear option” by the Delors Institute. A similar idea has been floated by Brussels in early 2019.⁴¹ The proposal is to establish a parallel dispute settlement mechanism in the WTO that excludes the US as long as it continues to refuse to approve new appointments to the AB, hence causing that body to become powerless toward the end of 2019 when it will lack its required minimum of three panel members. If this idea were to be adopted it would very likely lead long-time critic of the dispute settlement system Robert Lighthizer to recommend US withdrawal from the WTO to President Trump, himself an outspoken critic of that multilateral institution. It is difficult to imagine the WTO as a force to open trade absent US membership.

Nonetheless, these various proposals—and the endorsement of action by the G20, the trilateral group, and the MC11 Ministerial—provide support for the hard negotiations needed to bridge differences. In the next section I will outline some procedural recommendations for overcoming at least some of the obstacles to a successful negotiation. I would only note at this point that the US critique is a serious one and that the Trump administration clearly will not accept superficial solutions. Any resolution must address the problems of overreach by the AB, the lack of timely action by that body, decisions made on facts already decided by the first panel in a dispute settlement case, and any interpretation of local laws.

³⁹ “Statements by the United States at the Meeting of the WTO Dispute Settlement Body,” Geneva, August 27, 2018, especially item 4, https://search.yahoo.com/search;_ylt=AogeK.Of4olcRf4AYBIXNyoA;_ylu=X3oDMTBzMDYyanZhBGNybG8DYmYxBHBvcwMxBHZoaWQDBHNlYwNxcnc-?type=default&fr=yset_widemail_chr_win&ei=UTF-8&p=statements+by+the+united+states+at+the+meeting+of+the+wto+dispute+settlement+body+august+27+2018&fr2=12642

⁴⁰ Elvire Faubry and Eric Tate, “Saving the WTO Appellate Body or Returning to the Wild West of Trade?” (Paris: Notre Europe, Jacques Delors Institute, June 2018), p. 14, <http://institutdelors.eu/publications/sauver-lorgane-dappel-de-lomc-ou-revenir-au-far-west-commercial/?lang=en>

⁴¹ Ibid., p. 18. See also Adam Beshudi, “The China Pressure Cooker,” *Politico Morning Trade*, January 23, 2019, <https://www.politico.com/newsletters/morning-trade/2019/01/23/the-china-pressure-cooker-488549>.

Adapting New Rules for 21st Century Trading Patterns. The second set of priorities for WTO reform involve the need to develop or modernize rules covering new trade challenges and older subjects not adequately covered by existing disciplines. The inability of the WTO to agree on a comprehensive new set of rules since the birth of the organization in 1995 suggests that members should, as a minimum preliminary matter, focus their reform work on the most pressing current economic, political, and national security issues. Among these are new rules to address the resurgence of SOEs; an effort to bring as much of the services sector as politically feasible into the rules-based system; developing further new rules for trade in digital goods, services, and e-commerce; and modernizing rules for IPR protection.

To bring disciplines to the newly dynamic growth of SOEs, not only in China but in other leading economies like India, Brazil, Indonesia, and Russia, a number of steps need to be taken.⁴² A more precise definition of what constitutes an SOE, including tests for determining the sometimes subtle differences between commercial and non-commercial operations, is the first step in this effort. As noted earlier, subsidy transparency is also needed and disciplines for non-compliance like those proposed by the EU should be considered. More transparency about non-commercial assistance is also important. A better understanding of how state-directed operations may affect the definition of SOEs would also be helpful, especially with respect to China where guidance from Chinese Communist Party board members (required of all firms) or directly from government entities is prevalent. Finally, a more precise understanding of what constitutes a subsidy and thus becomes actionable in the WTO is also badly needed.

The IMF-World Bank-WTO paper previously discussed makes a good case for pursuing as broad an agreement as is politically possible for trade in services.⁴³ The most important US trade group for the broad services sector estimates that removing foreign barriers to trade in this sector could increase US exports by \$300 billion.⁴⁴ Given the increasing proportion and amounts of value added derived from services associated with the trade in goods, a factor that will only expand with the spread of digital trade and the Internet of Things, this element of the trade agenda may be the most important to future economic growth and a great boost to small and medium enterprises in both developed and developing countries. The most important components are probably financial and

⁴² A good summary of the issues surrounding new SOE rules is: Minwoo Kim, "Regulating the Visible Hands: Development of Rules on State-Owned Enterprises in Trade Agreements," *Harvard International Law Journal*, Vol. 58, No. 1 (Winter, 2017), pp. 225-272,

https://search.yahoo.com/search?p=regulating+the+visible+hands+development+of+rules+on+state-owned+enterprises&fr=yset_widemail_chr_win&type=default

⁴³ "Reinvigorating Trade and Inclusive Growth," op. cit. (Note 4)

⁴⁴ Coalition of Services Industries, "Promoting American Competitiveness Through Services and Digitally Enabled Trade," (Washington: Coalition of Services Industries, 2018).

https://search.yahoo.com/search?p=promoting+american+competitiveness+through+services+and+digitally+enable+trade&fr=yset_widemail_chr_win&type=default. An earlier estimate by the Peterson

Institute for International Economics had a much lower, albeit substantial estimate of around \$300 billion on an annual basis. See Gary Hufbauer and Jeffrey Schott, "Will the World Trade Organization Enjoy a Bright Future?" (Washington: Peterson Institute for International Economics, 2012). Policy Brief 12-11, p. 10,

https://search.yahoo.com/search?p=will+the+world+trade+organization+enjoy+a+bright+future&fr=yset_widemail_chr_win&type=default

business services, software, and digital commerce. It is worth repeating that digital commerce is especially important to small and medium enterprises and includes business-to-business as well as business-to-consumer transactions. Attention should be paid to commercial aviation and air transport services, although agreement in these areas, which are now covered by hundreds of bilateral “open skies” agreements, is probably years away from any type of consensus. New rules on SOEs are likely to be more important in the near term for this sector.⁴⁵

Analysts are paying particular attention to e-commerce and digital services. This emerging field is key to growth and opportunity across sectors and for large and small firms alike. It is an enabler of the IOT and key to the development of Artificial Intelligence (AI). In addition to rights of establishment and national treatment, important objectives for adequate WTO disciplines include prohibiting non-security related limits on free flows of data and data localization, regulatory transparency, maintaining the moratorium on e-commerce duties, preventing forced technology transfer and disclosure of source codes, and agreement on how to protect personal privacy.⁴⁶ On the issue of personal privacy protection, the United States and the EU will have to work to reduce differences in their approach. It is notable that in the recently completed EU-Japan economic partnership agreement, the parties did not cover cross-border data flow, committing only to “reassess ... the need for inclusion of provision on free flows of data.”⁴⁷ This is almost certainly due to the strongly held EU position on personal privacy protection. The new USMCA (and the original TPP agreement), which may fairly represent the US approach, has strong provisions for the free flow of data and against data localization.⁴⁸

The IPR protection rules are a subject of deep concern to the trilateral discussion on WTO reform. The three ministers have focused on addressing forced technology transfer and cybertheft of technologies and trade secrets. They also are discussing means to address “the systematic investment in, and acquisition of, foreign companies and assets to obtain technologies and intellectual property and generate the transfer of technologies to domestic companies.”⁴⁹ Additional work on protecting trade secrets and patents protecting biologics is also of considerable interest.

Finally, the IMF-World Bank-WTO study emphasizes the importance of foreign direct investment (FDI) to the modern global economy.⁵⁰ It estimates sales by foreign affiliates at \$38 trillion in 2016, compared to \$21 trillion in cross border trade in goods and services. Supply chains are dependent on FDI and the paths to reach foreign consumers frequently require close proximity to large population centers. Yet rules setting an agreed framework for FDI are “fragmented and complex,” relying on over 3000, mostly bilateral, investment agreements (BITs, in American parlance) outside the WTO framework. The Bretton Woods report calls for a “universal” approach that could

⁴⁵ “Subsidies and Unfair Competition,” *op. cit.* (Note 6), pp. 10-12.

⁴⁶ “Promoting American Competitiveness,” *op. cit.* (Note 44) and Business Software Alliance, “Trade and Global Markets,” www.bsa.org/policy/global-markets.

⁴⁷ See European Commission, “Key Elements of the EU-Japan Economic Partnership Agreement,” Brussels, July 6, 2017), [http://europa.eu/rapid/press-release MEMO-17-1903_en.htm](http://europa.eu/rapid/press-release_MEMO-17-1903_en.htm)

⁴⁸ Anupam Chander, “The Coming North American digital Trade Zone,” blog post, Council on Foreign Relations, October 9, 2018, <https://www.cfr.org/blog/coming-north-american-digital-trade-zone>

⁴⁹ “Joint Statement on Trilateral Meeting,” May 2018, Annexed Statement 2.

⁵⁰ “Reinvigorating Trade and Inclusive Growth,” *op. cit.* (Note 4), pp. 20-22.

“further the transparency and predictability of investment decisions, streamline and speed up investment processes, and foster international cooperation and best practices.”⁵¹ Increasing concerns about the national security implications of FDI, especially with reference to China and Russia, have led the United States and the EU to adopt new measures strengthening the scope of their regimes to review foreign investments (in the case of the US) or at least to coordinate approaches to review FDI (in the case of the EU).⁵² These new rules on FDI screening will complicate any “universal” agreement but should not preclude some broad discussions among like-minded WTO members to work toward consensus.

THE ROLE OF BILATERAL, REGIONAL AND PLURILATERAL AGREEMENTS IN WTO REFORM

Failure of Doha and New Importance of Bilateral and Regional Agreements. Since the WTO officially replaced the General Agreement on Tariffs and Trade (GATT) in 1995 there has been one attempt to craft a comprehensive new set of disciplines, the Doha Development Round which was launched in 2001. Talks have since floundered. Differences between developed and developing countries like India, Brazil, China (which insists on self-identifying as a developing nation) and the industrial powers led by the United States, the EU, and Japan, as well as long-standing differences between the United States and the EU over agricultural subsidies, have doomed the project to failure.⁵³ With 164 members featuring highly diverse economies and political systems, any agreement at the WTO, which requires an extremely high level of consensus, is all but impossible in today’s world. The Doha Round was effectively scuttled in 2015.

Progress in lowering trade barriers and adapting international rules for the modern globalized economy has been achieved over the past two decades through bilateral, regional, and plurilateral (WTO jargon for larger, multiregional discussions covering most trade in designated sectors) agreements. Examples of these in recent years are the EU agreements with Canada and Japan, the CPTPP, and the new US-Mexico-Canada (USMCA) arrangement. Bilateral deals like the Singapore-US free trade agreement are useful in developing and testing disciplines in new areas like services and digital trade. These sub-global agreements have addressed many of the shortcomings of the WTO outlined earlier in this paper. The CPTPP for example has very broad and specific rules covering SOEs and digital commerce, as well as good enforcement and dispute settlement features.⁵⁴ The USMCA also has comprehensive rules on digital commerce and free flows of data.⁵⁵ To be considered compliant with the global WTO rules,

⁵¹ Ibid., P. 21.

⁵² See Kate O’Keefe, “Treasury Spells Out New Rules on Foreign Deals Involving U. S. Technology,” *Wall Street Journal*, October 10, 2018, and Jonathan Stearns, “EU Set to Tighten Rules on Foreign Investment to Fend Off China,” *Bloomberg*, November 18, 2018.

⁵³ See Douglas Irwin, *Clashing on Trade: A History of US Trade Policy* (Chicago: University of Chicago Press, 2017), pp. 674-76.

⁵⁴ “Regulating the Visible Hand,” op. cit. (Note 42), pp. 242-244, 251. See also “Updating the Multilateral Rule Book,” op. cit. (Note 2), p. 3.

⁵⁵ Anupam Chander, “The Coming North American Digital Trade Zone,” blog post, Council on Foreign Relations, October 9, 2018, <https://www.cfr.org/blog/coming-north-american-digital-trade-zone>

bilateral and regional agreements generally need to cover 90 percent or more of trade between the contracting parties.

If broader reform and expansion of disciplines to new areas under the WTO umbrella proves to be unattainable, aggressively pursuing “coalitions of the willing” or “fast and slow lanes” through bilateral and regional pacts will help to elucidate new paths for liberalization that could eventually be globalized. It could also help brake any retreat toward outright protectionism.

Working Within the WTO on Creative Use of Plurilateral Agreements.

One of the best options for reform is the use of plurilateral agreements under the umbrella of the WTO. The most important example of this process is the 1996 Information Technology Agreement (ITA) signed at the Singapore Ministerial Conference by 29 mostly industrialized member nations. This agreement covered most information technology products (not services) and was implemented on the basis of unconditional MFN. That is, all members of the WTO were automatically granted the tariff and other benefits of the new agreement, including the zero-tariff standard for covered IT products. The original signatories accounted for a “critical mass,” in this case, over 90 percent of all trade in IT products. These two features, unconditional MFN and coverage of most trade, qualified the agreement as valid under WTO rules even though only a minority of member countries were involved in the negotiation and final agreement.⁵⁶ The product coverage under the ITA has been updated in recent years to reflect the rapid evolution of this industry, but digital services and data protection and flows have not come under full WTO coverage.

The limiting factor inherent in the MFN requirement, as shown in the ITA agreement, is important and one of the major impediments to progress in the WTO system. Most agreements are the result of compromise and mutual concessions among negotiating parties. Under the MFN principle, the 29 original signatories received no concessions from the more than 100 other WTO members. This is an unusual case covering a new, dynamic industry with considerable dominance by a limited number of countries that share a general consensus on the value of tariff and tax-free trade to allow the rapidly growing industry to prosper. Most traditional industries, by contrast, have entrenched economic and political support in each country which makes concessions difficult absent reciprocal concessions by other parties. As trade scholars Hufbauer and Schott explain: “Whatever its virtues, the unconditional MFN principle creates an open door for free riders and an exit path from reciprocity when concessions among a few countries are extended without cost to all WTO members.”⁵⁷

The Issue of MFN Requirements. When confronting the highly contentious issues raised earlier in this paper, it is clear that WTO reform will be difficult within existing arrangements, given the rather strict MFN requirement. There is a means for WTO members to waive the MFN requirement under Article IX(9) for new rules, but it requires a three-fourths majority to invoke.⁵⁸ There is one exception to the three-fourths

⁵⁶ See “Will the World Trade Organization Enjoy a Bright Future?” op. cit. (Note 44), pp. 7 and 15.

⁵⁷ Ibid., p. 7.

⁵⁸ Ibid.

supermajority test, and it covers the important services sector. The WTO disciplines under the General Agreement on Trade in Services (GATS) chapter allow plurilateral agreements in this sector without a supermajority vote.⁵⁹ Given the economic importance to the modern economy of services trade and investment, and the fact that negotiations on new rules were launched in 2012, there is some optimism about progress in this vital sector, which includes digital services. As noted earlier, 70 nations are now engaged in talks to develop a consensus on e-commerce alone.⁶⁰

Nonetheless, because of the reality of the MFN requirement for changes to WTO rules, most experts and commentators on both sides of the Atlantic expect any substantial progress on the other important questions facing the trade institution to be led by regional and plurilateral agreements. The Bretton Woods group study states rather clearly that the path to eventual WTO reform will most likely lie with “open” plurilaterals and regional agreements that allow members to opt in to new sets of disciplines originated by smaller, *ad hoc* groupings of the membership:⁶¹

But where (multilateral) reform is not initially possible, advancing within the WTO systems through other approaches, including plurilaterals, has often been seen as preferable by many WTO members compared to advancing outside the system.

There are already more than 250 regional trade liberalizing agreements in force, and these continually prove to be test beds and proving grounds for ideas to improve the global trading system.

The major challenge of reforming the operations of the WTO will require substantial political will to achieve. It is encouraging that the trilateral group and the group organized more recently by Canada are addressing the issues in a constructive way. But persistent differences between the United States and the EU over the work of the AB, which are threatening to freeze the work of this body in late 2019, require urgent attention. To overcome the historical WTO requirement for consensus, the trilateral group will have to lead the way. An eventual solution to the AB problem could open the door to some form of “Grand Bargain” as proposed by Hufbauer and Schott by restoring confidence in the dispute settlement process and the primacy of the membership in making WTO rules. A series of plurilaterals on issues like services, SOEs, trade facilitation, and perhaps even currency valuations, agricultural subsidies, and investment could follow.⁶² The trilateral group will have to be convincing enough to win three-fourths votes on exempting new agreements from the unconditional MFN requirement for sectors other than services, and on changes in the operations of the WTO itself. Otherwise, the process will devolve into expansion of regional agreements with the hope that their best features can eventually be incorporated into the WTO system.

⁵⁹ *Ibid.*, p. 5.

⁶⁰ “Updating the Multilateral Rule Book,” *op.cit.*, (Note 2), p. 1.

⁶¹ “Reinvigorating Trade and Inclusive Growth,” *op. cit.* (Note 4), p. 5. On the number of RTAs in force see p. 33.

⁶² “Will the World Trade Organization Enjoy a Bright Future?” *op. cit.* (Note 44). The authors may not agree with all suggestions in this paper, but the outline of a “Grand Bargain” is theirs.

CONCLUDING REMARKS

The WTO—and its predecessor the GATT—has been a crucial component of the global, rules-based system conceived at Bretton Woods after World War II. It has helped generate unprecedented peace and prosperity around the world. Unfortunately, in recent decades its rules have not kept pace with changes in the 21st-century economy. The evolution of politics in developed countries has also contributed to increased scrutiny and sensitivity about the localized negative effects of globalization. Partially as a result of these factors, criticism of the organization has grown in many important member countries. Its internal functioning, especially related to the dispute settlement mechanisms set up by the WTO, has been a major focus of discontent.

To address the problems, concerted effort by the traditional supporters and architects of the WTO, especially the United States and Europe, will have to overcome irritants in their economic and political relations. Constructive ideas have been advanced by transatlantic officials and scholars, and several influential groups of members are working to find solutions to the various issues. Creativity and compromise will be required on all sides to find workable solutions. But the economic importance of crafting them, and the need to reduce the political tensions which they engender, make the process well worth the effort.

Hudson Institute is a research organization promoting American leadership and global engagement for a secure, free, and prosperous future.

Founded in 1961 by strategist Herman Kahn, Hudson Institute challenges conventional thinking and helps manage strategic transitions to the future through interdisciplinary studies in defense, international relations, economics, health care, technology, culture, and law.

Hudson seeks to guide public policy makers and global leaders in government and business through a vigorous program of publications, conferences, policy briefings and recommendations.

Hudson Institute

1201 Pennsylvania Avenue, N.W.
Suite 400
Washington, D.C. 20004

P: 202.974.2400
info@hudson.org
www.hudson.org