Optimal remedies in international trade agreements

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ABSTRACT

This paper takes a mechanism-design approach to characterize a politically optimal trade agreement under the assumption that governments have private information about the fluctuating political pressure they face from domestic interest groups to restrict trade. The optimal mechanism under these changing circumstances involves a remedy system for breach of trade agreements that specifies less-than-proportional retaliations against deviating parties. This result is in contrast to the conventional wisdom in the literature regarding the efficiency of the Reciprocity Principle as a rule of renegotiation in trade agreements. I also consider an institutional structure in which only commensurate retaliations are practical but governments can employ a public randomizing device to authorize retaliations. I show that it is optimal to authorize retaliations only randomly. This suggests a role for the WTO dispute settlement process as a public randomizing device.

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1. Introduction

Viewing international trade agreements as contracts among politically motivated governments has been a popular thesis among scholars. Following this paradigm, different aspects of trade agreements have been analyzed using insights from contract theory. In particular, attempts have been made to understand the renegotiation and compensation provisions in trade agreements as mechanisms to promote efficient breach of contracts. This paper contributes to this literature by characterizing the most efficient remedy system for violation of trade agreements among politically motivated governments.

In this paper, I take the view that by signing trade agreements, governments try to maximize their political welfare in an uncertain political and economic environment. In the absence of cooperation, each government uses its trade policy instruments too aggressively so that the political welfare reaped by one government comes at a higher cost to other governments. Governments can escape from this Prisoners' Dilemma by entering into an agreement that limits their ability to manipulate trade policy instruments.[1] Nevertheless, governments may occasionally find themselves under intense pressure from domestic interest groups to deviate from their international trade obligations. In such circumstances, taking a protectionist measure to dissipate political pressures in the importing country may cause more political gains to the

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  [1] Bagwell and Staiger (1999) and Bagwell and Staiger (2002, Chapter 2) provide an elegant formulation of this idea.

government of the importing country than costs to the government of the exporting country. In other words, abiding with the agreement in the presence of intense political pressure causes a net loss in terms of joint political welfare.

Under most trade agreements, signatories are free to suspend or withdraw their obligations without the consent of other contracting parties. In response to this initial violation, however, the affected parties will be also free to suspend substantially equal obligations or concessions. Withdrawal of previously granted concessions by the victim countries can be interpreted as a form of remedy for breach of contracts. Sykes (1991) and Schwartz and Sykes (2002) interpret the authorization of reciprocal reaction to an initial deviation as an award of "expectation damages", which places the victim in as good a position as it would have been in if the violator had honored its obligations. Following this definition, Schwartz and Sykes (2002, p. S182) argue that "expectation damages thus deter inefficient breach because the promisor will not wish to violate and pay expectation damages unless the promisor gains more from the breach than the promisee loses, in which case breach is efficient."

In this paper, however, I argue that a system that employs expectation damages, the so-called liability rule system, is not the most efficient mechanism for handling breach of international trade agreements. The point of departure is the observation that an injured party in an international trade setting usually receives compensations by withdrawing its own concessions that have been previously granted to the offending country. This method of compensation is efficiency-reducing since, as discussed above, withdrawal of concessions in normal situations causes a net loss to the contracting parties. In fact, an important underlying assumption on which the efficiency of a liability-rule mechanism is established is the availability of cash transfer, or other efficiency-neutral side payments, as a method of compensation. When such efficiency-neutral side payments are not available, it is in the best interest of all parties, ex ante, to agree on a remedy system that awards the smallest possible damages to victims.[2]

Notwithstanding its inefficiency, awards to the victim cannot be reduced to zero if governments have private information regarding the state of the world. That is because in the absence of a system that imposes sufficient costs on breaching parties, governments will have the incentive to exaggerate the political and economic costs of honoring their trade obligations in order to legitimize their protectionist pursuits.

In Section 4 of this paper, I model a trade agreement as an optimal mechanism whose objective is to maximize the joint political welfare of the governments while it induces truthful revelation of private information by all parties. The main finding is that an optimal mechanism involves less-than-proportional retaliation against deviating parties. This result appears to be different from Bagwell and Staiger's (1999) general conclusion that the restriction of reciprocity directs the bargaining outcome toward the political optimum. Bagwell and Staiger (1999) show that under the restriction of reciprocity, negotiators have no incentive to negotiate away from a first-best trade agreement that generates the highest joint welfare under the current state of the world. While confirming this result, I show that when the state of the world changes so that the current agreement is no longer the first-best, the reciprocity principle does not direct the negotiators to the new first-best agreement. More importantly, I show that the outcome of renegotiations under the reciprocity rule falls short of second-best optimality.

Moreover, my finding does not support the proposals to allow for more-than-proportional retaliation against a violating country in the WTO. I argue that these proposals do not follow an efficiency rationale; instead, these are motivated by the observation that reciprocity does not compensate a breached-upon party for all of its loss. As Bagwell (2008) correctly points out, "commensurate retaliation preserves the terms of trade but results in a reduced trade volume. Hence, […] commensurate retaliation leaves the foreign government with less welfare than it would have enjoyed at the initially negotiated tariffs." In other words, a liability-rule mechanism prescribes a more-than-proportional retaliation, which, as I show in this paper, is not optimal.

In Section 5, I consider an institutional setting in which disproportionate retaliation is not practical but a public randomizing device is available that can be used to authorize retaliation on a random basis. This institutional configuration may have some practical appeal. First, as Howse and Staiger (2005) and Bagwell (2008) point out, important measurement problems significantly limit the feasibility of a system with disproportionate retaliation. Second, one can interpret the WTO dispute settlement system as a public randomizing device that authorizes retaliation with a fixed probability. I find that the optimal probability of retaliation is strictly less than one. Optimality of random, rather than certain, retaliation once again indicates the fact that reciprocal retaliation is too severe to induce efficient behavior by governments.

Before concluding this paper I will discuss the fairness of the optimal remedy system in Section 6. One may argue against a system that authorizes less-than-proportional retaliation by questioning the fairness of the system. In fact, as noted above, a victim is not fully compensated under an optimal remedy system in the WTO. However, ex ante, that is, when political pressures are not yet realized, the expected value of the agreement is the same to both governments. Therefore, governments maintain a balance of concessions ex ante, although such a balance may not materialize ex post. Moreover, if governments have repeated interaction over time, a country that stands to lose from an optimal remedy system in some periods will be overcompensated in periods when it finds it optimal to suspend its obligations in response to domestic pressures. In other words, governments can maintain an intertemporal balance of concessions under an optimal trade agreement through repeated interactions.

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[2] Feenstra and Lewis (1991) consider a situation where rents can be transferred among countries. Their findings can be interpreted as supporting a liability-rule system.