Strengthening the Rules-Based Trading System
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Preface

The G-20 is the world's preeminent economic forum. The issues that confront the G-20 leaders and the way they go about addressing them can have a disproportionate impact on small open economies in Africa, including on our own, Morocco.

In no field is this more evident than in international trade and investment. Morocco’s trade represents 88% of its GDP, higher than that of any of the G-20 members. Foreign investment, especially that related to global value chains, is of crucial importance to Morocco. Thanks to that investment, in 2017 Morocco produced over 350,000 cars and commercial vehicles and is now the largest vehicle producer in Africa. Morocco, like the rest of Africa, depends crucially on an open and predictable world trading system and the laws enshrined in the World Trade Organization, founded in Marrakesh in 1995.

That is why the Policy Center for the New South supports the trade work of the think-tanks that develop the policy brief for the G-20 leaders, the T-20. It does so in a modest way by devoting the time of one of our Senior Fellows and by publishing in this volume the seven policy briefs of the T-20 Task-Force on Trade, Investment and Globalization. As part of our effort to disseminate the ideas contained in these briefs, we translated the executive summary in Arabic and French so that they can reach a wider readership in Africa and in the Arab world.

The hard work that enables the production of this report was led admirably by the Research Institute of Trade, Economy and Industry (RIETI) and by the Asian Development Bank Institute (ADBI). The papers were drafted by an extraordinarily capable group of international experts led by Professor Fukunari Kimura of Keio University and his co-chairs which include our Senior Fellow Uri Dadush. These individuals and the lead-authors of the policy briefs are flagged in the main text. I take the opportunity to congratulate them all for the work done and to thank RIETI and ADBI and the Japanese Presidency of the G-20 for the opportunity given to us to publish this short report.

Karim El Aynaoui
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Executive Summary

The world trading system has been remarkably successful in many respects but is presently under tremendous strain. The causes are deep-seated and require a strategic response. The future of the system depends critically on reinvigorating the WTO and policy change in the largest trading nations. Important measures are required to sustain the multilateral trading system, and urgent action is needed to avoid a scenario where the system fragments. The worst scenarios will disrupt global trade and see a world which splinters into large trading blocs (most likely centered around China, the European Union and the United States) and where trade relations are based to a large extent on relative power instead of rules. In such a world the smallest players, such as those in Africa and especially those whose trade depends on unilateral preferences and is least covered by bilateral or regional agreements will be at the greatest disadvantage. All countries will incur enormous costs only to try and reinvent a system that is already in place today under the WTO.

The dysfunction of the WTO as a forum for trade liberalization and trade related rule-making contributes to the sense of crisis. The G20 should tackle this challenge in a proactive and innovative manner by reinvigorating the WTO as a forum for negotiation. Possible policy options include multilateral agreements with multi-speed implementation focused on specific themes or sectors. Plurilateral agreements and critical mass agreements, i.e. those which involve a subset of the membership, should be enabled, while remaining open to all parties who wish to join them and accept obligations. Priority, however, should be given to multilateral agreements with multilanes. Possible themes for such negotiations include e-commerce and investment facilitation.

An additional major challenge confronting the WTO is the failure to agree to replace the members of the WTO Appellate Body (AB) whose terms have expired, due to criticisms from certain WTO Members regarding the procedures and functioning of the AB. The criticisms include overreach and slowness. There are several options to respond to these criticisms, including expanding the membership of the AB and agreeing on guidelines on what the AB can cover in its rulings and under which conditions the AB can decide not to take up a dispute. If the AB ceases to operate, back-up procedures may include resort to arbitration and to countermeasures under established international law, although none of these options is likely to prove satisfactory.
A big new issue that the WTO should tackle relates to digital trade, which was essentially nonexistent when the organization was established in the mid-1990s. The digital economy provides ample opportunities for the G20 to accelerate inclusive economic growth. To take advantage of digital technology, free flow of data backed up by a series of policies to address other public policy objectives must be promoted. However, policies for the flow of data and data-related businesses are still underdeveloped and fragmented across countries. Ample controversy exists around possible rules for digital trade, but it is incumbent on the G20 to design and implement a series of policies as soon as possible. Standard microeconomic theory can provide a very useful starting point for the formulation of such policies.

Structural changes in the world economy, including digital trade and the ease with which information flows internationally have altered the way we think about the nexus between trade and growth. The rise of the services economy and the digital revolution have transformed international trade in ways that are not nearly sufficiently reflected yet in the G20 policy process. G20 policy-makers must pay greater attention to trade in services and its crucial role in achieving the G20’s growth and inclusion objectives.

Another structural change owes to the rise of Global value chains (GVCs), networks of firms engaged in various stages of the production and distribution process through international trade of goods and services, investment, and research activities. These networks are not new but they have expanded enormously throughout much of the world in the 1990s and early 2000s. GVCs generate benefits for both advanced and developing countries through efficiency gains, lower prices, diversification, knowledge diffusion and job creation. However, the expansion of GVCs has slowed since the global financial crisis in 2007-2008 because of human capital (skills) and infrastructure constraints, as well as regulatory and institutional barriers. The GVCs’ adverse effect on some manufacturing firms in advanced countries of competition from emerging countries have contributed to the rise of protectionist sentiments and policies.

The G20 can facilitate the expansion of GVCs by agreeing to support increased attention to developing human capital and infrastructure, promoting business matching, removing regulatory and institutional barriers, upgrading the manufacturing sectors in advanced countries, and eschewing protectionist measures.

A crucial element in the operation of successful GVCs is international direct investment. There is growing support amid the international community for an international framework to facilitate such investment and its contribution to sustained development. The G20 should adopting Guiding Principles on Investment
Facilitation for Sustainable Development. Such principles would include: orient and promote investment facilitation, especially sustainable FDI; integrate such facilitation throughout the investment lifecycle; engage in broad-based stakeholder consultations; share responsibilities among investors, host nations and origin nations; encourage cooperative activities, adopt a whole-of-government approach to investment facilitation; operate within a multilateral framework, and support capacity building coupled with flexibility.
TRADE, INVESTMENT AND GLOBALIZATION

The Crisis in World Trade

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Abstract

This policy brief (PB) provides decision-makers with a succinct review of the state of the trading system, to point to likely scenarios, and to serve as a background to or reference for the other six PBs prepared by the T20 Task Force on Trade, Investment and Globalization. The brief argues that the world trading system has been remarkably successful in many respects but that the present strain reflects causes which are deep-seated and require a strategic response. The future of the system depends critically on reinvigorating the WTO and policy change in the largest trading nations. Important measures are required to sustain the multilateral trading system, and urgent action is needed to avoid a scenario where the system fragments. The worst scenarios will disrupt global trade and see a world which splinters into large trading blocs (most likely centered around China, the European Union and the United States) and where trade relations are based to a large extent on relative power instead of rules. In such a world the smallest players – especially those whose trade is least covered by bilateral or regional agreements – will be at the greatest disadvantage. All countries will incur enormous costs only to try and reinvent a system that is already in place today under the WTO.

1 We thank Richard Baldwin, Eduardo Bianchi, Wallace Cheng, Manjiao Chi, Christopher Findlay and David Laborde for very helpful comments.
Proposal

The world economy has never been as closely integrated as it is today. International trade in goods and services as a share of world GDP has increased from around 35% in the mid-1980s to around 60% today, despite a hiatus during the global financial crisis. Yet, the world trading system is now confronted by an unprecedented crisis. How this crisis is resolved depends on whether the WTO can be revitalized, whether the United States reverts to its traditional role of lynchpin of the system, and whether China can adopt reforms that address the concerns of its main trading partners. While there are no sure answers to these questions, in this note we present scenarios that help bracket the uncertainty and hopefully suggest an appropriate and robust policy response.

1. The trading system is now showing signs of stress on three main fronts

First, the inability of the WTO to make progress in critical areas such as services, agricultural subsidies, investment, the facilitation of global value chains, and digital trade, is calling into question the value of the organization and the sustainability of the system of laws that it constitutes. While many poor countries feel let down by the failure to conclude the Doha Round, the industrialized economies believe that there needs to be a rebalancing of obligations between them and the most successful emerging economies, who are also now among the largest trading nations. It appears increasingly difficult to build effective coalitions to reach acceptable deals along the North–South divide.

Second, the impasse over the appointment of Appellate Body members

2 The United States has recently tabled a paper at the WTO proposing criteria for developing country status, which is currently established by self-designation, so, for example, Singapore, one of the world’s richest nations and South Korea are developing nations in the WTO. Under the criteria proposed by the United States, these countries, but also China and India would no longer qualify. China, India, South Africa and others submitted a proposal of their own to reiterate that self-declaration is appropriate in the WTO context and that per capita indicators must be given top priority when assessing development levels. This is bound to become another major area of dispute going forward.
threatens to bring the WTO’s dispute settlement system to a halt. The concerns that has led to one country blocking new appointments relate to concerns over whether the Appellate Body has added to or diminished rights and obligations and over procedural practices.

Third, the festering of tensions is observed in a series of trade restrictive measures and countermeasures without due regard to the WTO law. Some of the trade restrictive measures are taken in response to, rightly or wrongly, perceived theft of intellectual property, forced technology transfer, and widespread and opaque subsidization, especially of state-owned enterprises (SOEs), among other reasons. Some observers believe that state-led economic systems are incompatible with membership in the WTO while others believe that changes in the WTO rules are necessary and feasible. A number of countries share many of the concerns and consider proposing WTO rule changes, even as they disagree on methods.

Unfortunately, geopolitical rivalry and technological competition may complicate any solution. The trade tensions carry the risk of a significant deterioration not only in the openness and predictability of world trade but also of international relations and the ability to cooperate on the provision of other global public goods, such as the control of carbon emissions and the achievement of the Sustainable Development Goals.

The current frictions may well have led to permanent damage, since they are not only eroding the credibility of the WTO, but they are also encouraging countries that are so inclined to weaken or reject the rules-based multilateral trade system.

2. The causes of the current attack on the trading system run deep, reflecting a growing resistance to globalization; they require a strategic response.

The increased resistance to globalization is primarily a result of the secular trend in skill-biased technological change which accounts for rising inequality, economic disruption, and the stagnation of most incomes, a trend especially evident in advanced countries, but not only there.
Globalization also contributes to increased disruption and inequality directly because it creates demand for higher skills disproportionately and gives rise to many “winner-takes-all” opportunities, especially for platform companies that can scale-up quickly and inexpensively. The disruption has been made worse by the rapid rise of newly developed economies and the coming onstream of low-skilled workers across the developing world. The shift of manufacturing from advanced countries and many developing nations to China has been especially painful. In addition, the Great Recession, surges of migrants and refugees, and terrorism exacerbated the problem. Rightly or wrongly, large current account and bilateral imbalances remain a source of tension. Although China's current account surplus has essentially vanished, and the deficit of the United States has declined from around 7% of GDP at the peak to around 3% of GDP, the bilateral imbalance remains big. Germany and several other countries continue to run very large surpluses.

Populist and nationalist leaders are presently capitalizing on the fear of globalization to erect trade and investment barriers and to severely restrict immigration. However, it is important to note that a vast majority of businesses, especially export interests, opposes protectionism. With the advance of globalization export interests have gained in power relative to import-competing interests. Moreover, with raw materials, parts and machinery accounting for 75% of world trade\(^3\), businesses are worrying about the viability of global value chains on which they rely. Young people – the voters of tomorrow – are generally opposed to protectionism as well. As protectionism takes hold, consumers see prices rise and their choice diminished, and they, too, tend to react. Many nowadays see their ability to buy foreign goods, invest and travel abroad as a natural right. For all these reasons, most large nations remain committed to increased openness in trade and foreign investment.

Economic analysis shows that protectionism is not the right answer to the problems, which instead lies in paying more attention to the plight of the most vulnerable. Ex ante policies include investment in skills and infrastructure, or more generally in policies that improve competitiveness, and ex post policies include measures to share the gains from global integration\(^4\). However, the

\(^3\) UNCTAD, 2017
\(^4\) See Akman et al., "Mitigating the Adjustment Costs of International Trade" 2018 T20
national populists have refused this course – preferring the blaming of foreigners and protectionism. Meanwhile, mainstream politicians are hampered by budget constraints in pursuing policies that enhance public investment and social welfare.

3. The world trading system rests on three main pillars, the WTO, preferential trade agreements and domestic institutions, and it has been remarkably successful.

The WTO is a global public good which supports open and predictable trade based on reciprocity. It now includes 164 members accounting for 98% of world trade, with another 22 at various stages in the process of accession. Although in recent years, trade liberalization has occurred far more rapidly outside the WTO than inside it, the WTO provides the bedrock of international trade law. The principles of non-discrimination across nations, the Most Favored Nation clause, and within the national border, the National Treatment clause, and the disciplines agreed under the WTO represent the baseline, or the reference point, for other trade agreements as well as for domestic commercial law.

Under WTO rules, preferential trade takes three main forms: unilateral, as in the granting of preferences to poor countries under the GATT 1979 Enabling Clause; bilateral, which are allowed conditionally under GATT Article 24 of the WTO (substantially all trade and tariff reductions); and regional or Mega-regional, also under Article 24.\(^5\)\(^6\) According to the WTO, at the start of 2019, 291 regional trade agreements were in force. Trade agreements now cover over 60% of world trade, and the share is rising.\(^7\) Many of the bilateral and regional agreements include rules and liberalization commitments which extend well

\(^5\) GATT Article 5, on Freedom of Transit, and its relationship to e-commerce may also be mentioned here.

\(^6\) Several “plurilateral” agreements also exist under the WTO, such as the Government Procurement Agreement and the International Technology Agreement.

\(^7\) For example, members of the EU – the largest trading block – conduct about 64% of their total trade within the EU and, of the 36% conducted outside the EU, about one third was covered by trade agreements with third parties. This share increased greatly with the recent conclusion of the EU-Japan and EU-Canada treaties.
beyond present WTO disciplines to cover behind-the-border barriers to trade and new issues such as e-commerce or the role of SOEs. The EU, NAFTA, and ASEAN free trade agreements have been especially successful in supporting regional production networks and accelerating industrialization. In the last year, notable new trade agreements included EU-Japan, EU-Canada, and the CPTPP. In March 2018, the African Continental Free Trade Agreement was signed which showed promise that global value chains may become more functional in the region. Some trade agreements are now entering a second generation, such as NAFTA/USMCA. While the possibility of Brexit looms, the European Union, the largest trade agreements is continuously being deepened and several countries have expressed interest in acceding.8

International commercial disputes are prevalently resolved in domestic, not international, courts. Domestic institutions – the rule of law - that affect or directly govern international trade are crucial and they are being continuously reformed. Although some of these reforms have moved in the direction of trade restrictions (Global Trade Alert points to several thousand such measures enacted by G-20 nations since the outbreak of the global financial crisis), for the most part the trend over the last several decades is in the direction of facilitating international trade. For example, in the process of joining the WTO, China changed over 2000 laws and regulations. The European Union has reformed its common agricultural policy so as to greatly reduce its reliance on trade-distorting subsidies and has discontinued the use of “zeroing” in the calculation of anti-dumping margins. Until recently, the United States had discontinued use of Section 301 as inconsistent with WTO commitments. It is worth noting that international trade has also been facilitated by the building of trade, transport and communications infrastructure. This process is especially vital in developing nations.

The combined effect of multilateral, regional, and domestic reforms on the freedom and predictability of trade has been remarkable. The MFN applied tariffs of developing countries have been cut to a fraction of what they were in

8 Several other bilateral and plurilateral agreements could be mentioned which fall outside the ambit of the WTO, such as over 2000 Bilateral Investment Treaties, Double taxation treaties, the WIPO Convention, etc. whose effect is directly or indirectly to promote trade or to enhance the benefits of trade.
the mid-1980s. And exports from the poorest countries now enter advanced countries duty-free and quota-free in the vast majority of cases. The effectively applied tariffs (which take account all preferential agreements) are now very low in most large and middle-sized trading nations. For example, in Morocco, which has negotiated several bilateral trade agreements and reduced its MFN tariffs autonomously, the effectively applied tariff rate is now near 4%. Behind-the-border barriers and non-tariff barriers at the border are difficult to measure but they clearly continue to represent a considerable impediment to trade. However, these barriers have not prevented trade in goods and services and capital flows from becoming a much more prominent feature of economic activity.

4. The future of the multilateral trading system hinges on the answer to three related questions.

There is no definite answer to the following questions, but one can identify possible answers, or scenarios, that are favorable to the continuation of the multilateral trading system (Scenarios “A”). Likewise, there are scenarios that would not be favorable to multilateralism (Scenarios “B”).

*Can the WTO be reformed so that its negotiating arm begins to make progress on the most crucial issues?*

Scenario “A”. The answer is that it can, on condition that the membership can agree to move forward on specific issues and to address them through “plurilateral” agreements (See PB2 for detailed proposals)). These would involve members who represent a critical mass of trade and who are willing to grant concessions to non-participants on an MFN basis. The critical mass requirement may be less important in the case of agreements on rules, where free riding concerns are less prevalent than agreements on market access. This would allow members who are willing to go ahead with rule-making in specific areas to do so, while helping those who consider such rules to be premature see
how the rules may work in practice. It is also possible that deals can be struck where members accounting for a critical mass of trade can strike a plurilateral agreement that is not MFN as the Government Procurement agreement which was sanctioned under the Uruguay Round. It is difficult, however, to imagine that plurilateral agreements can be reached without concurrence of the major trading nations, underscoring the need for the United States, China, the European Union and Japan, among others, resolving their present differences.

Scenario “B”. If the WTO negotiating arm is not revitalized, the institution will lose significance and its judicial role will also be undermined. Even if the institution retains some influence since many of its provisions have been incorporated in domestic laws, it will become increasingly irrelevant to the solution of longstanding issues such as agricultural subsidies and investment, and 21st century issues such as digital trade and the support of Global Value Chains. One of more nations, especially the major powers, may conclude that the constraints of WTO membership outweigh its benefits. Countries will rely on a combination of bilateral trade agreements, partial plurilateral trade agreements, norms from the WTO days, and power relations among the major nations where bilateral agreements are difficult to envisage at present as among China, the EU and the US. The world may move rapidly into an era of aggressive unilateralism. Smaller nations who have not struck bilateral agreements with the big three will be especially hard-hit.

_Do current US trade policies constitute a new normal in the United States or do they reflect a temporary phase?_

Scenario “A”. Many of the current concerns behind the trade tensions are expected to persist. However, most American politicians and American businesses do not favor a lawless trading regime even if they do not exclude a power-based approach to induce negotiations or to deal with perceived infractions by state led capitalism. All major countries still seem willing to engage in WTO reform. One thing that is unclear is the question of whether the
United States will challenge the WTO dispute settlement system only on procedural grounds – in which case solutions may be found – or whether it has more fundamental concerns relating to sovereignty. The assumption here is that the United States will accept procedural changes in the WTO dispute settlement system that address its concerns (See PB 3 for more detail).

Scenario “B”. The U.S. leaves the WTO (de facto or de jure) following a politically unacceptable unfavorable panel decision on an important dispute, such as the U.S. use of the section 232 national security justification for its steel and aluminum tariffs, or on China’s market economy status. Other countries may then need to face the reality of a WTO without the United States. If the United States reverts to a policy of isolation and protection – as it did over much of the 19th century and early 20th century, MFN treatment or better may no longer become a norm for a large part of its trade. At the same time, many countries will seek to strike a bilateral deal with the United States to ensure continued access to an important market. Over time, the United States may well become less competitive and less attractive as an investment destination. The United States’ global influence will rely increasingly on its military might, and it may wane in the area of international economic relations. China and, to a lesser degree, the European Union and Japan may play an increased role in the economic sphere.

*Is a state capitalist system compatible with the WTO and if so, can the reforms needed to address the concerns of main trading partners be implemented?*

Scenario “A”. China is not the only provider of state aid, opaque subsidies, and is not the only nation to rely on State Owned Enterprises. However, its size, growth rate, and its history of central planning make it unique. As a major beneficiary of the system, China is clearly committed to the WTO and more broadly to policies of closer integration into the global economy. However, China’s size, its large state sector, and the considerable extent to which provinces can pursue economic policies in a decentralized fashion, means that
the reforms needed to reduce subsidization and the scope of the state sector are complex, politically extremely sensitive, and will take time. China’s trading partners must strike a balance between the exercise of continuous pressure for change and the risk of encouraging the forces within China that want it to turn inwards and adopt a defiant stance.

Scenario “B”. China is reluctant or is unable to undertake the reforms to its system that are required to create a more level playing field in international trade. Tensions with the United States and its allies escalate. As in the scenario where the United States turns inwards, all aspects of international relations become more complicated.

5. In addressing the implications of these scenarios, policy makers should assume that globalization will persist even though it may slow temporarily as the trading system runs into severe difficulties.

The present era of globalization has coincided with unprecedented rates of economic growth and poverty reduction, even though the gains it has generated have been spread unequally. Globalization, of which trade is the main vector, will continue. To see why, it is useful to keep the three forces behind it in mind.

First, globalization is a spontaneous economic process driven by producers and consumers who engage in arbitrage (buy low, sell high) in the world markets for goods, services, capital and labor. Human beings will continue to engage in this arbitrage, which they do as naturally as they breathe. The arbitrage process across the four markets is mutually-reinforcing. Developing economies, which represent a rapidly rising share of world economic activity, are especially in need of these exchanges to import technology and know-how in exchange of their abundant labor and natural resources.

The synergistic arbitrage process in the four markets is greatly facilitated by improvements in transportation and information technologies, which reduce
“trade costs”, including “communication costs” and “face-to-face costs”\(^9\). These improvements have enabled a significant transformation in the international division of labor from industry-wise to production process-wise or task-wise beginning around 1990. And now, we are experiencing a drastic reduction in matching costs for business-to-consumer and consumer-to-consumer transactions, which may trigger the development of massive service outsourcing. These changes are expected to continue and even accelerate due mainly to the advances in information technologies. Cross-border data flows have seen explosive growth and one estimate suggests that international broadband use will increase by 9 times over the next 5 years\(^{10}\). Already 12% of global trade is carried out on e-commerce platforms which did not exist a few years ago.

It is true that historically, policies, macroeconomic depression, and international conflicts have interrupted globalization in individual countries and regions in many instances, and, sometimes even across the world, as in the 1930’s. In the current era, higher trade barriers, and new impediments to international investment can certainly slow globalization directly and by causing a sharp deceleration of economies. However, history teaches that a withdrawal from globalization is not technologically or economically sustainable. Politically, countries that have withdrawn from globalization have often also had to resort to repression. In shaping their long-term strategy, policy-makers should not assume that this time is different.

6. Accordingly, policy makers need to take several actions to avoid a widespread resurgence of protectionism that could severely dent economic growth across the world.

Policy-makers should adopt measures that aim to achieve the best scenario while also preparing contingency plans for the worst.

Policy-makers should assume that no single economy, even the largest, can isolate itself from the globalization process. Indeed, the more other countries

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\(^9\) Baldwin “The Great Convergence”

\(^{10}\) Mc Kinsey, 2019
engage in liberalization and adopt rules-based approaches to trade, the greater the advantage of becoming part of the system and the greater the disadvantage of those who stand outside it.

Accordingly, policy-makers should accelerate their efforts at striking bilateral and regional trade agreements, to engage in domestic reforms that improve their international competitiveness and facilitate integration in global value chains, and to reinvigorate the multilateral system. They should renew their pledge to avoid protectionism. When retaliating against unilateral tariffs, their response should be proportionate and time-bound and subject to periodic review. These steps will increase the pressure on all countries to remain within the system. They are also steps that guard against the worst consequences of bad scenarios, should they materialize.

As indicated in the G20 communique’ of 2018 and 2017, countries should adopt measures that aid the adjustment of the most vulnerable to the spread of labor-saving technologies and of international trade involving low-wage economies. These policies may include gradualism in trade reforms in some instances, but ultimately require international cooperation and the pursuit of ex ante and ex post domestic policies that help ensure global economic engagement does not increase inequality.

The G20 should reinvigorate the WTO as a forum for negotiation. As argued in PB2, possible policy options include multilateral agreements on a specific issue with distinct lanes and speed for advanced, developing and least developed countries, as in the case of the Bali Trade Facilitation Agreement. Plurilateral agreements, especially those that allow for MFN treatment of non-participants, or those that allow for participation and eventual accession of all members appear especially promising. Possible themes for negotiation include E-commerce and investment facilitation. Policy-makers need to support WTO reforms in critical areas such as the operation of global value chains (See PB611)

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11 PB 6 expresses concern on the slowdown of the expansion of global value chains (GVCs) after the Global Financial Crisis and claims that GVCs must be further developed by providing proper policy environment, promoting business matching, and reducing protectionist sentiments.
and services (See PB 5\textsuperscript{12}). The facilitation of investment requires changes in procedures which are uncontroversial – so do not include market access, investor state dispute settlement – and represent a low-hanging fruit (See PB7\textsuperscript{13}). Rules that govern digital trade, which is burgeoning, are urgently needed. These rules should aim for the ideal of free digital trade while addressing the legitimate concerns that relate to privacy, security, etc. (See PB4\textsuperscript{14}). Monitoring and transparency need to improve all round\textsuperscript{15}.

Policy-makers need to make procedural changes to the WTO dispute settlement system that improves the speed and thoroughness of the system. They also need to address more fundamental questions such as the appropriate use of precedent and those relating to “judicial activism”. While they need to bear in mind the concerns of the United States, the focus should be on making the system work better for all parties (See PB 3\textsuperscript{16} for a comprehensive proposal by WTO law scholars). Policy-makers should make full use of the dispute settlement process whenever they determine that rules have been broken and their interests have been harmed.

Countries with very large current account surpluses should revisit the appropriateness of their macroeconomic and taxation policies. Policy-makers

\textsuperscript{12} PB 5 warns G20’s relative negligence on trade in services and appeals that strong, sustainable, and inclusive growth will not be achieved without due consideration of services responding to the recent rise of the services economy and the digital revolution.

\textsuperscript{13} PB7 reiterates the previous T20 claim that an international framework to facilitate investment is crucial to take advantage of the globalizing momentum for sustainable development and proposes Guiding Principles on investment Facilitation for Sustainable Development.

\textsuperscript{14} PB 4 emphasizes the importance of digital technology for G20 economies to accelerate sustainable and inclusive growth and claims that free flow of data can be placed as a logical starting point to design and verify a series of supporting policies to address people’s concerns and various public policy objectives.

\textsuperscript{15} see Lamy and Mehta \url{https://www.thewire.in/trade/what-should-the-role-of-g-20-countries-be-in-reforming-the-wto}

\textsuperscript{16} PB3 proposes a number of important procedural changes to the WTO Dispute Settlement process, including those related to deadlines, rules for outgoing Appellate body members, and findings unnecessary to the resolution of a dispute. The brief also includes proposals for fundamental reforms, such as those relating to the use of precedent, “judicial activism”, independence of the Appellate Body. The brief also discusses alternatives should the current system falter, such as arbitration under DSU Article 25 and Countermeasures under general international law.
should recognize that neither global nor bilateral trade imbalances can be effectively corrected through trade policy measures, only though changes in macroeconomic and structural policies.

China, which is by some measures already the world’s largest economy and appears destined to become the largest trading nation by a wide margin, must rapidly adopt reforms and a stance that correspond to its new-found status. Carrying its fair share in the WTO includes lowering its MFN applied tariffs, adopting stringent rules on subsidization, on protection of intellectual property and on the rights of foreign investors. The disciplines governing SOEs – in China and elsewhere – must be such as to minimize their distorting effect on international trade. The best way to achieve these reforms is through a multilateral effort in which China is a leading participant.

The United States, which has long been the lynchpin of the international trading system, has legitimate concern to push for changes in some aspects of the current system. Continuation of the present system – albeit with certain needed reforms - is in the vital economic and security interests of the United States. It should, however, exercise its power to change the system from within.

Preparing for the worst scenarios requires envisaging a world which splinters into large trading blocks (most likely China, the European Union and the United States) and where trade relations are based to a large extent on relative power instead of rules. In such a world the smallest players – especially those whose trade is least covered by bilateral or regional agreements - will be at the greatest disadvantage. However, businesses based in the large blocks will also find that they face a far less open and predictable trading environment, while consumers face higher prices, diminished variety and, in many instances are forced to settle for lower quality goods and services. In such a world, policymakers will be faced with a choice of retreat and protection – an unsustainable course - or of urgently negotiating new bilateral and regional agreements which include effective dispute settlement procedures. They will incur enormous

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costs only to reinvent a system that is already in place today under the WTO.

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TRADE, INVESTMENT AND GLOBALIZATION

Reinvigorating the WTO as a Negotiating Forum

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Abstract

The multilateral trading system is on the verge of a crisis arising from, among others, the dysfunction of the WTO as a forum for trade liberalization and trade related rule-making. The G20 should tackle with this challenge in a proactive and innovative manner by reinvigorating the WTO as a forum for negotiation. Possible policy options include multilateral agreements with multi-speed implementation, plurilateral agreements and critical mass agreements, but priority should be on multilateral agreements with multi-lanes. Possible themes for such negotiations can be e-commerce and investment facilitation.
Challenge

The multilateral trading system is on the verge of a crisis, arising from three distinct situations. First, trade restrictive measures and the reactions against them, many of which were recently applied by G20 countries, could place the global economic recovery in jeopardy, and some of the measures were applied without due regard to the relevant rules of the WTO. Second, the WTO dispute settlement mechanism is on the verge of crisis, as certain members obstruct the appointment of new members of the Appellate Body after the expiration of the terms of its members. Third but not least, the Doha Development Agenda (DDA) didn’t work, and the initiatives since the 2013 Agreement on Trade Facilitation do not help update the 24-year-old WTO rules to reflect modern realities of global economy characterized by globalization of value chains and digitization of trade.

As the first and the second situations are dealt with in Policy Briefs 1 and 3, respectively, this Policy Brief will deal with the third situation, namely, the dysfunction of the WTO as a forum for trade negotiation.

This trend has caused serious issues which has eroded the centrality of the WTO as a forum for trade negotiation. First, substantive trade liberalization and trade related rule-making are being conducted outside of the WTO through so called mega-FTAs such as CETA, CPTPP and Japan-EU EPA. Second, a limited number of WTO members are the parties to such FTAs, to the exclusion of the vast majority of WTO members, most of which are developing countries and LDCs. It must be noted that the “Global” Value Chains in fact span across a small number of countries selected by leading firms in the light of optimum alignment

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of production processes across borders. Accordingly, if mega-FTAs cover existing “Global” Value Chains with no movement in the WTO, it risks locking in the current divide between those countries who join the “Global” Value Chains and those who do not. Third, as FTAs are not necessarily uniform, the rules overall might become fragmented.

Proposal

It is high time that the G20 takes responsibility for the WTO again. Many G20 members have been playing significant roles in tackling pressing issues of global economic governance by swiftly developing innovative ideas and applying them. The G20, an informal body comprising relevant members of the WTO representing both developed and developing countries, should tackle the dysfunction of the WTO as a forum for trade negotiation in a proactive and innovative manner.

The WTO should be reinvigorated as a forum for negotiation

If the Doha stalemate persists and the mega-FTAs continue to set 21st century trade and investment rules, the WTO will fade over time, losing its centrality at least as a forum for trade negotiation. With the exception of the Agreement on Trade Facilitation, rules of the WTO date back to 1995. Substantive trade liberalization and trade related rule-making are being conducted outside of the WTO, particularly through the negotiation of mega-FTAs among those countries comprising GVCs. As this may result in the fixation of the current divide between those countries who join the GVCs and those who do not, the WTO should be revitalized as a forum for trade negotiation, so that its members, 4 See Baldwin (2012: 11). (Stressed that “the vast majority of WTO members are only tangentially involved in supply-chain trade. ... The parties that would really have to agree would be the old Quad and the new manufacturing giants, particularly China.”)

5 For instance, the rules on E-commerce in the TPP and the Japan-EU EPA (Economic Partnership Agreement) are different in several respects, for instance the prohibition of requiring localization of computing facilities (Article 14.13.2 of the TPP, while the Japan-EU EPA does not provide for this.).
in particular LDCs, may have a better chance of joining the “Global” Value Chains.

We therefore welcome the recent initiatives by G20 countries for WTO reform, including the EU's concept paper,\(^6\) Joint Statement on Trilateral Meeting of the Trade Ministers of the U.S., Japan and the EU,\(^7\) and Ottawa Ministerial on WTO Reform,\(^8\) as they address how to reinvigorate the negotiating function of the WTO. We also welcome the works that are being undertaken through the Joint Statements Initiatives from MC11,\(^9\) as they aim at restoring the negotiating function of the WTO. A good news is that 76 members of the WTO announced the launch of negotiation on rules of e-commerce in late January.\(^{10}\)

These are our proposals for reinvigorating the WTO as a forum for negotiation. They consist of two sets of proposals, namely, proposals on negotiating and decision-making procedure and proposals on the subject matter for negotiation.

\(^9\) See: Joint ministerial statement: Declaration on the establishment of a WTO informal work programme for MSMEs (WT/MIN(17)/58); Joint ministerial statement on investment facilitation for development (WT/MIN(17)/59); Joint statement on electronic commerce (WT/MIN(17)/60); Joint ministerial statement on services domestic regulation (WT/MIN(17)/61), 13 December 2017.
1. Proposals on negotiating and decision-making procedure

Opinions abound on introducing flexible approaches to WTO negotiations, instead of the single undertaking formula with consensus decision making. 11

Ironically, the Doha stalemate was a victim to the success of the Uruguay Round single undertaking. Developing countries, after experiencing the North-South “grand bargain” of the Uruguay Round, 12 raised their level of expectations from the Doha Development Agenda, as they claimed that the “grand bargain” did not deliver the benefits that they had expected. Their high expectations contrasted with developed countries' demand of securing substantively improved market access from emerging market economies, and this gap resulted in the prolonged disagreement between these two groups of WTO members. 13

In light of this, the WTO members gave up the single undertaking approach at MC8 in December 2011, and they agreed to reach partial agreements earlier than the full conclusion of the single undertaking, where progress can be achieved on the elements of the agenda items. 14 This enabled the adoption of the Agreement on Trade Facilitation at MC9 in December 2013, and, among others, the agreement on the abolition of export subsidies on agricultural products at MC10 in December 2015. The WTO members should maintain this approach, and aim at the early harvesting of as many items in the remaining Doha agenda items as possible, in such areas as disciplining fisheries subsidies.

11 See, Basedow (2018) (Argues for a carefully crafted approach to plurilateralism in the WTO); Collier (2006: 1433-1436) (Proposes linking plurilateralism to transfers to developing country members.); Cottier (2015: 17-18) (Emphasizes the need of sectorial negotiations, resulting in specific agreements, which may be universal, plurilateral or “critical mass” approach.); Hoekman and Mavroidis (2015) (Support greater use of plurilateral agreements.); IMF/World Bank/WTO (2018: 32-36) (Argues for alternative approaches to single undertaking.); Lawrence (2006: Proposes supplementing the core WTO obligations with a club-of-clubs approach.); Trebilcock (2015) (Argues for the need to be more accommodating of plurilateral agreements among sub-sets of WTO members that are open to subsequent accession by other members, primarily on a conditional MFN basis.)

12 See Ostry (2002).

13 See Elsig (2016).

14 See WTO 8th Ministerial Conference, Chairman’s Concluding Statement, 17 December 2011, WT/MIN(11)/11, p.3.
In the forthcoming negotiations of the WTO, the single undertaking approach should be avoided. The WTO members should rather pursue as many options as practicable. They include multilateral agreements (e.g., most WTO Agreements and the Agreement on Trade Facilitation), plurilateral agreements with a limited membership but open to accession (e.g., Agreement on Government Procurement), and “critical mass” agreements negotiated by a subset of WTO members, whose benefits are extended to all members on an MFN basis (e.g., Information Technology Agreement in 1996 and its expansion in 2015, GATS Protocols on Basic Telecommunications and Financial Services in 1997, and an agreement on environmental goods currently under negotiation).

1.1 A critical mass approach is preferable for trade liberalization

Experiences tell us that a “critical mass” approach is effective and efficient in reaching agreement on sectoral market access on trade in goods as well as services. This approach should be a priority in this type of negotiation at the WTO. On the other hand, this approach may not be adequate in rule-making negotiations, as this will create a situation where rules (obligations) negotiated and agreed among a limited number of WTO members will be applied to those members who did not join the negotiation. According to the fundamental rule of consent (pacta sunt servanda) under international law, those countries who are not the parties to an agreement are not obliged to apply the rules of the agreement. Accordingly, rule-making negotiation should result in either a multilateral agreement where all the WTO members join the negotiation, or a plurilateral agreement applied only to those WTO members who joined the negotiation.

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15 See WTO 11th Ministerial Conference, Ministerial Decision of 13 December on Fisheries Subsidies. WT/MIN(17)/64.
16 Note that alternative to abandoning the Single Undertaking should not be a WTO á la carte, but the approaches encouraging the eventual participation of all members, while preventing a blockade in the process.
1.2 A multi-speed multilateral agreement is preferable for rule-making

A multilateral agreement and a plurilateral agreement have both advantages and challenges. A multilateral agreement creates rules that are applied to all WTO members. It should, therefore, be a preferred approach from the viewpoint of inclusiveness and universal application of rules. On the other hand, this approach will take longer to negotiate than a plurilateral approach, and WTO members may have varied ambitions and readiness in reaching agreement. One way to overcome the difficulty in negotiating a multilateral agreement would be to introduce multi-speed implementation for developing countries and LDCs, and for developed countries and the WTO Secretariat to provide implementation assistance to LDCs. The Agreement on Trade Facilitation is a good example.

A multilateral agreement with multi-speed implementation has three advantages. First, it enables all WTO members to join the agreement according to self-determined selection of provisions with self-determined grace periods. Second, it is consistent with the GATT/WTO practice of self-designated developing country status, while it provides developing country members incentives to full implementation. Third, it creates a sense of solidarity among the WTO members through the implementation assistance from developed countries. Its downsides are that it could take longer to negotiate than a plurilateral agreement, and even longer to achieve full implementation.

1.3 An open plurilateral agreement can be an alternative for rule-making

A plurilateral agreement is binding among those who joined the negotiation. It does not extend its obligations to non-parties. As it is an agreement among like-minded members, its negotiation may be concluded earlier than that of a multilateral agreement on the same topic. The downside of plurilateral approach is that it may result in a divide in the WTO membership, and the WTO may become a two-track regime, where a subset of countries or a “club” play

17 Note that incentives come from (1) implementation assistance provided by developed country members, and from (2) the fact that those countries who implement the agreement fully may attract private firms that constitute GVCs.
according to the plurilateral agreement. Furthermore, latecomers face a series of pre-determined rules that they have not negotiated and may not be ready to adopt.

It is, therefore, critical for any plurilateral approach to ensure mechanisms that safeguard the interests of those WTO members who either did not join the negotiation or do not become parties to the agreement. First, a plurilateral agreement should be open to all WTO members in the negotiation stage. Second, it should also be open to all WTO members after its entry into force. However, these are not enough, as LDCs are least likely to engage in the negotiation and implementation of plurilateral agreements on rules. So, as a third mechanism, a plurilateral agreement should be equipped with an aid-for-trade component, which assists LDCs in improving their domestic regulations to the level that is required under the agreement.18

Another challenge is that the addition of a new plurilateral agreement to Annex 4 must be decided by consensus (Article X.9 of the Marrakesh Agreement Establishing the WTO). This means that any WTO member can veto the adoption of the proposed plurilateral agreement.19 As it is unrealistic to expect that WTO members will agree to amend this provision, a method should be developed to relax the consensus requirement in adding a new plurilateral agreement to Annex 4. One possibility might be to require those members who do not agree to the addition to explain the reasons for their opposition.20

2. Proposals on the subject matter

2.1 Liberalization of trade in goods and services

Forthcoming negotiations at the WTO should aim at enhancing WTO members’ liberalization commitments in trade in goods and services, and at modernizing its rules to meet the changes in global trade since 1995. Priority should be put on those areas that are already under negotiation, such as liberalization of

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19 See Draper and Dube (2013: 3-4).
environmental goods and trade in services. The G20 countries should support
the process of these negotiations. A critical mass approach including as many
developing country members as possible can be a method of facilitating
multilateralization and liberalization. While the negotiation of the
environmental goods agreement is conducted by a “critical mass” approach, the
Trade in Services Agreement (TiSA) is being negotiated as a plurilateral
agreement, whose benefit will be applied solely to participants. In light of the
stringent consensus requirement under Article X.9 of the Marrakesh
Agreement for adding a plurilateral agreement to Annex 4, the TiSA is likely to
become a preferential trade agreement, rather than a plurilateral agreement.
As this could contribute to sidelining the WTO as a forum for trade negotiation,
countries negotiating the TiSA should pursue the adoption of a “critical mass”
approach, as appropriate, so that it may be located within the WTO.

2.2 Candidates of negotiation for rule-making

There are two sets of rules that the WTO should focus on. The first set relates
to modernizing the rules of the WTO in new areas that didn’t fully exist when
the WTO was established. The second set relates to tightening or expanding the
existing WTO rules to deal with trade distorting practices in such areas as
subsidies and state-owned enterprises (SOEs).

On modernizing the rules of the WTO, priority should be put on those areas that
are covered by the Joint Statements Initiatives from MC11, namely, (1)
MSMEs (micro, small and medium-sized enterprises), (2) electronic commerce,
(3) investment facilitation for development, and (4) services domestic
regulation. It must be noted that 76 members of the WTO announced the launch
of negotiation on rules of electronic commerce in late January. G20 countries
should support these initiatives, and those G20 countries who are currently not

Available at <http://ec.europa.eu/trade/policy/in-focus/tisa/>
22 See WTO 11th Ministerial Conference, Joint Ministerial statement – Declaration on the
establishment of a WTO informal work programme for MSMEs (WT/MIN(17)/58); Joint
ministerial statement on Investment Facilitation for Development (WT/MIN(17)/59); Joint
statement on Electronic Commerce (WT/MIN(17)/60); Joint Ministerial statement on
services domestic regulation (WT/MIN(17)/61).
the parties to these initiatives should consider joining them.

In deciding the form of negotiation and decision-making, priority should be placed on multi-speed multilateral agreements where all WTO members join the negotiation and implementation, as they will become important regulatory infrastructure for streamlining the GVCs. MSMEs and electronic commerce are also important themes for securing inclusiveness in international trade. As previously mentioned, WTO members may have varied ambitions and readiness in reaching agreement, so that a multi-speed implementation by developing countries and LDCs with implementation assistance should be adopted to ensure the gradual and universal implementation of these multilateral agreements.

An open plurilateral agreement might be an alternative form of negotiation, but its adoption should be conditioned on the aforementioned mechanisms to secure its openness and inclusiveness, namely, (i) it must be open to all WTO members at the negotiation and the implementation stages, (ii) it should be equipped with an aid-for-trade component, and (iii) consensus requirement for addition to Annex 4 should be mitigated.

Another area that should be considered as a candidate for rule-making at the WTO is related to the tightening or expansion of existing rules to deal with trade distorting practices, such as industrial subsidies, SOEs, transfer of technology and trade secrets, and transparency. As these issues are deeply political among G20 countries, a realistic first step for G20 countries will be to start discussion and study and framing of these issues, so that they may deliver the result of discussion at the MC12 in Astana in 2020.

A summary of recommendations:

G20 countries should strive to reinvigorate the WTO as a forum for trade liberalization and trade related rule-making.

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24 See European Commission, Concept Paper, WTO modernization, supra n.5; Joint Communiqué of the Ottawa Ministerial on WTO Reform, supra n.7.
For trade liberalization, priority should be on a critical mass approach.

A multi-speed multilateral agreement is preferable for rule-making, but an open plurilateral agreement can be an alternative.

Rule-making should aim at modernizing rules to meet the current challenges (e.g., e-commerce and investment facilitation), and at tightening existing rules to deal with trade distorting practices (e.g., subsidies and SOEs).

References


Reforming the WTO AB: 
Short-term and Mid-term 
Options for DSU Reform, and 
Alternative Approaches in a 
Worst Case Scenario

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WTO Members have failed to agree to replace the members of the WTO Appellate Body (AB) whose terms have expired, due to criticisms from certain WTO Members regarding the procedures and functioning of the AB. This Policy Brief explores possible options to reconcile these criticisms, including both short-term and mid-term options. It also explores a legal course of action for WTO Members if these options were not taken.
Challenge

No one doubts that the WTO dispute settlement mechanism (DSM), which is embodied mainly in Understanding on rules and procedures governing the settlement of disputes (DSU), has provided one of the most successful international dispute settlement fora. WTO Members, however, now doubt this “crown jewel” of the WTO can continue to work as efficiently and effectively as ever, due to serious difficulties it faces currently. These include:

1. **Serious delays in appellate review**

As its caseload has grown, the AB has increasingly been unable to observe the 90-day deadline to issue its reports (DSU art.17.5). This tendency has been observed since 2011. Out of the 40 completed appellate reviews since then, the AB circulated its report in time only in 5 cases. Appellate review has taken 117.9 days on average,1 and this figure increases to 180.2 days if cases only after 2011 are taken into account.

Multiple factors cause this delay in addition to the increased caseload. These include increased complexity of certain cases, litigation strategies that have resulted in longer and more complex legal arguments in the appellate review, and an understaffed Secretariat.

2. **Legitimacy crisis of the AB**

Certain Members have severely criticized the AB for engaging in *ultra vires decision-making* (“overreaching”), adding to or diminishing the rights and obligations of the Members under the WTO Agreement, contrary to its mandate in the DSU (DSU art.3.2). This allegedly amounts to judicial law-making, even though the AB faithfully, in its view, observes customary rules of interpretation.

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of public international law (DSU art.3.2).²

In one case, the AB was also accused of a lengthy obiter dictum, which is allegedly an “advisory opinion” beyond the AB’s mandate.³ The AB also inevitably discusses issues unnecessary for the resolution of a specific dispute, since the DSU art.17.12 requires it to address every issue raised by an appellant and/or an appellee. Another cause of concern for certain WTO members is that these interpretations and judicial opinions are treated as precedent to be generally followed in subsequent cases.⁴

The so-called “Rule 15 issue”⁵ is another reason for the legitimacy crisis of the AB. Certain Members believe outgoing AB members should not, without authorization by the Dispute Settlement Body (DSB), continue to serve on appeals that they were assigned to before the expiration of their term of appointment.⁶

All these concerns have served to undermine the legitimacy of the AB.

3. Impasse over appointment of the AB members

The two sets of concerns above have resulted in a disagreement among WTO Members over filling vacancies on the AB. Mr. Shree Baboo Chekitan Servansing, who completed his first term in September 2018, was the fourth member to have left the AB without a replacement appointment being made.

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⁴ 2018 Trade Policy Agenda, supra note 2, at 28.
⁵ Rule 15 of Working Procedures for Appellate Review (WT/AB/WP/6, Aug. 16, 2010) provides as following: “A person who ceases to be a Member of the AB may, with the authorization of the AB and upon notification to the DSB, complete the disposition of any appeal to which that person was assigned while a Member, and that person shall, for that purpose only, be deemed to continue to be a Member of the AB.”
Now the AB has only three members, which is the minimum that the DSU requires to compose a division to review a case. The terms of two of them, Messrs. Thomas Graham and Ujal Singh Bhatia, will expire on December 11, 2019, which means the AB is at the brink of effectively becoming defunct. Outstanding cases are also increasing.

At the same time, we observe that recent trends towards protectionism and unilateralism have resulted in an increasing number of disputes being brought to the WTO. 39 complaints were brought before the DSB in 2018. This number is the 3rd largest since the establishment of the WTO. In addition to these new disputes, 14 appeals were currently pending as of March 1, 2019.

Proposal

The authors appreciate the contribution that the AB has made to promoting a more transparent, predictable and stable world trade order over the past 24 years. The authors believe that it is essential to ensure judicial independence of the AB, and that political interference by WTO Members should be avoided in addressing DSU reforms.

At the same time, the authors believe that it is imperative to strike an appropriate balance between judicial independence of the AB and proper policy space of Members through legitimate reform proposals. While the authors by no means take the package of criticisms of the AB as a given, they are nevertheless sympathetic to a range of concerns expressed, primarily though not exclusively by the US.

The authors urge, as a priority at the forthcoming G20 Summit in Osaka, that G20 leaders take the first step towards the ultimate goal of achieving institutional and procedural reform of the WTO DSM. For this purpose, the authors would like to present several policy options in this Policy Brief in relation to: (1) Institutional and Procedural Reform of the DSU; and (2) Alternative Approaches, if the deadlock remains.
1. Institutional and Procedural Reform of the DSU

Background

Despite cynicism and pessimism regarding prospects for drastic reform of the WTO DSM, it is imperative for WTO Members, including all the G20 economies, to make strenuous and good faith efforts to normalize the system. Indeed, WTO Members may find themselves in a worst case scenario where, faced with measures that have been found by a panel to be in breach of the WTO agreements and unable to pursue an appeal, they feel compelled to counter such measures if they are not withdrawn. However, such a situation would seriously undermine the WTO and its dispute settlement regime. WTO Members should step-up and face the necessity of institutional and procedural reforms of the WTO DSM.

Many WTO specialists have published proposals for possible solutions since the AB crisis emerged. Some WTO members, including Australia, China, Chinese Taipei, EU, and Honduras also submitted communications regarding potential DSU reforms and solutions to the current AB crisis. The authors believe that these include a number of useful suggestions.

Among these proposals, a communication submitted last December by the EU and eleven co-sponsors including China, India, and four other G20 economies is a good basis for our discussion. The communication includes; (i) transitional rules for outgoing AB members, (ii) the issue of 90-day deadline, (iii) the meaning of municipal law as an issue of fact, (iv) findings unnecessary for the resolution of the dispute, and (v) the issue of precedent. Items (i) through (iv), in particular, seem sound and relatively feasible due to their technical nature, and fit for “early harvest”.

All these proposed amendments address aspects of the “overreach” concerns, and should generally find broad acceptance among WTO Members including

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7 See the items in the References.
8 Communication from The European Union, China, Canada, India, Norway, New Zealand, Switzerland, Australia, Republic of Korea, Iceland, Singapore and Mexico to the General Council, WT/GC/W/752 (Nov. 26, 2018).
G20 economies. The communications by other WTO members largely follow this classification of issues and supplement the proposals by the EU and the co-sponsors, which we will, therefore, review one by one below.

**DSU Reforms that are feasible in the short to mid-term**

**(i) Transitional rules for outgoing AB members**

The EU and co-sponsors suggest an amendment to the DSU by inserting a rule that “an outgoing AB member shall complete the disposition of a pending appeal in which a hearing has already taken place during that member's term.” The authors support the basic idea.

Alternatively, the authors would suggest a simpler approach without amendment of the DSU. Rule 15 of the Working Procedure of Appellate Review triggered the controversy, and a serious concern regarding the rule was that an outgoing member continues to serve on a pending appeal without authorization by the DSB. Therefore, the authors propose to replace the phrase “with the authorization of the AB and upon notification to the DSB” in Rule 15 with “with the authorization of the DSB”.

Regarding this proposal, some might be concerned with a risk that, in some cases, the DSB might not reach “consensus” on continuation of service by an outgoing member. As Honduras proposes, WTO Members need to discuss the applicability of a negative consensus approach, or the consensus minus the parties to the pending appeal(s).9

On the other hand, the authors fully understand the concern of certain Members that it is undesirable and inappropriate to authorize unfettered continuation of service after the expiration of the term of an outgoing member. As Honduras proposes, in order to minimize the outgoing member’s continued service and avoid last minute assignment of pending appeals, WTO Members

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9 Fostering a Discussion on the Functioning of the AB: Communication from Honduras, WT/GC/W/759 (Jan. 21, 2019).
could decide, for example, “[a]n AB member shall be able to continue to serve on cases where the oral hearing has occurred or started”, or “[n]o member of the AB shall be assigned to a new appeal later than 60 days before the final date of his/her appointment.”

(ii) The issue of 90-day deadline

The essence of the EU and co-sponsors’ proposal on this issue is to allow the AB to exceed the 90-day deadline with consent of the parties to the appeal. If the parties do not reach consensus on the extension, according to the proposal, the AB can exercise moderate discretion to propose to the parties to limit the scope of their appeals, or take appropriate measures to reduce the length of its report. Also, the EU and co-sponsors attempt to limit the burden of translating the report before the 90-day deadline.

The authors believe that this proposal, together with detailed options presented by Honduras to ensure efficiency of the appellate review, is a useful starter for discussions. DSU art.3.3 provides, “[t]he prompt settlement...is essential to the effective functioning of the WTO”. From this perspective, meeting the 90-day deadline is imperative for the AB. WTO Members should contrive an effective method for the timeline management.

At the same time, we should be careful in imposing limitations on the scope of the appeals, opportunities for disputing parties’ written submissions and oral hearings, and the volume of the report. Dispute settlement in the WTO must not only be “prompt”, but also be “positive” (DSU art.3.7), and the AB reports assist in clarifying the meanings of existing provisions of the WTO Agreement (DSU art.3.2). An excessive stress on brevity might harm these important aims and functions of both the AB and the DSM. The authors believe that it is essential for the WTO Members, in addressing the issue of the 90-day deadline, to strike a proper balance between “prompt settlement” and “positive solution” of

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10 Id.
11 WT/GC/W/752, supra note 88.
12 WT/GC/W/759, supra note 9.
disputes.

In addition, the authors feel it necessary to address this issue from a broader perspective. The length of each appellate review is a function of the workload of the specific case and resources available in the review. Taking into consideration the number of AB members and the legal officers in the Secretariat, the members’ limited availability due to their part-time status, and increasing factual/legal complexity in recent appeal cases, it might not be practical to complete appellate review within the 90-day deadline. Setting a longer deadline, e.g., 120 days, or increasing human resources in the Secretariat could be more a realistic solution.

(iii) The meaning of municipal law as an issue of fact

The proposal by the EU and co-sponsors inserts in DSU art. 17.6 a new footnote to the effect that “issues of law” does not include the panel findings regarding the meaning of municipal measures of a party, but does include those regarding their legal characterization under the covered agreement, which is subject to the appellate review. This draft footnote codifies the interpretation of DSU art. 17.6 developed by the AB in its precedents. The authors agree with that approach.

(iv) Findings Unnecessary for the Resolution of the Dispute

DSU art. 17.12 requires the AB to address “each of the issues” raised before it. It is a common understanding that this paragraph does not allow the AB to exercise so-called “judicial economy”, i.e., abstention from reviewing the issues

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13 Id.
that are unnecessary for the resolution of the dispute. It renders the AB unable to take the minimalist approach with due deference to the policy space of WTO Members. To eliminate the deficiency, the EU and co-sponsors attempt to insert a phrase “to the extent necessary for the resolution of the dispute” into DSU art.17.12. The authors support this approach.

That said, the authors also believe that it is worth considering an interpretative approach to that effect. The AB once opined, though in the minority view, that it is its legal duty to address each of the issues before it, and in deciding how to address the issues, it is guided by the objectives of the "prompt settlement" of a dispute or "positive solution to a dispute". Thus, according to its view, the AB may decline to make specific findings regarding all issues raised on appeal, and address issues only to the extent necessary to ascertain that there was no need to rule on that particular issue in question.\(^{15}\)

The approach taken by the minority view seems to interpret the duty of the AB under DSU art.17.12 in the light of DSU arts.3.3 and 3.7. In the authors’ view, this is a sound contextual interpretation consistent with the Vienna Convention on the Law of Treaties (VCLT) art.31.1. If this interpretation is acceptable to WTO Members, the authors believe that EU and co-sponsors’ goal in this respect could be achieved without amending the DSU art. 17.12.

**More ambitious reforms to be addressed in a longer term**

**(i) The issue of precedent**

While items (i) through (iv) above are rather technical, item (v), *i.e.*, the issue of precedent, is of a different nature.

The US expressed its concern\(^{16}\) about the AB’s opinion that security and predictability are the centerpiece of the WTO DSM and, therefore, that “absent


\(^{16}\) *U.S.: WTO AB rulings should not be considered precedent*, INSIDE US TRADE, Dec. 25, 2018, at 8.
cogent reasons, an adjudicatory body will resolve the same legal question in the same way in a subsequent case”.17

While it is quite clear that there is no *stare decisis* in the WTO dispute settlement rules, a system of influential —albeit non-binding— precedents has evolved since the days of the GATT 1947. Evidently, neither panel nor AB decisions happen in a vacuum. Panels have looked at and considered decisions issued by other panels before them on the same or similar issues since before the advent of the WTO, and the AB has looked not only to its own prior decisions, but, indeed, also to panel decisions in cases other than the one under review. “WTO jurisprudence” has become a term of art that reflects the system of *influential precedents*, which has undoubtedly contributed to the “security and predictability” of the DSM and, in turn, strengthened the world trading system.

A panel has emphasized the importance of the security and predictability of the multilateral trading system to private economic actors in the global market.18 The authors agree with the opinion. No private economic actors would appreciate inconsistent applications of the WTO Agreement. Thus, departure from prior decisions should not be taken lightly. It should be well thought out, clearly and thoroughly reasoned if it is to be persuasive. Therefore, recognizing the non-binding nature of prior decisions, the authors advise WTO Members to be cautious about any change that might weaken this unique body of precedents.

As Honduras suggests, technically speaking, there may be ways to prohibit or limit the doctrine of precedent.19 The authors, however, expect WTO Members to weigh the pros and cons of such options, and carefully examine likely consequences of those options.

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The EU and co-sponsors’ proposal in this regard suggests holding an annual meeting between the AB and WTO Members to discuss “concerns with regard to some AB approaches, systemic issues or trends in the jurisprudence”. The authors support the idea. As a first step, the AB and the WTO Members could discuss the concept of “a cogent reason” including, for example, what reason can be “cogent” and in what situation panels and the AB in subsequent cases are allowed to depart from earlier approaches to comparable issues.

The authors recognize that the proposal is far from fully accommodating the deep concern expressed by the US on judicial lawmaking through the precedent. However, as the authors discussed above, change in this practice could seriously undermine security and predictability in the world trading system. Therefore, the authors recommend WTO Members to establish a framework for regular exchanges of views between WTO Members and the AB.

(ii) Other issues in relation to “Judicial Activism” of the AB

In addition to the issue of precedent, we now face several other problems regarding the legitimate role of the AB. These include;

– appellate review of fact finding by a panel;

– legal interpretation in accordance with the customary international law;

– advisory opinion and abstract discussion regarding the WTO Agreement (obiter dicta):

Honduras has submitted a communication regarding these issues. It presents to WTO Members a variety of options designed to constrain the AB’s role in the appellate review. These include mandatory judicial economy, a general prohibition on engaging in obiter dicta, and instructions on the interpretative
While the authors agree that judicial activism by the AB is not desirable, they are worried that such a ‘no-go zone’ approach might result in excessive interference with, and undue chilling effects on the AB’s review. Besides, it is difficult for WTO Members to successfully draft meaningful guidelines for appellate review regarding the above issues in the short-term, though such approach may potentially be more realistic than achieving agreements on textual amendments to the DSU. For instance, an interpretative approach is contingent upon a specific text before the adjudicator, and such a nuanced and subtle process cannot be codified in a general guideline in a clear-cut manner. The guideline must also be carefully drafted so as to be consistent with “customary rules of interpretation of public international law” (DSU art.3.2) embodied in the VCLT arts. 31 and 32. The authors would not say drafting such guidelines is impossible, but there is no doubt that it is formidable and quite time consuming. A more flexible approach is desired.

The crux of the issue is whether the AB accurately understands the shared view of WTO Members on the reach of the appellate review in a timely manner. For this purpose, the authors believe that a dialogue between WTO Members and the AB members on a regular basis, mentioned in (i) above, would be desirable on these issues as well. Through direct and frequent exchanges of views between the AB and WTO Members, the AB members could tailor the appropriate exercise of judicial discretion to meet the WTO Members’ needs.

The authors’ comments so far are not intended to deny the concerns of the US about judicial activism. The authors would not prejudge the appropriateness of the AB’s manner of interpreting the covered agreements and exercising its judicial discretion. In this regard, Australia and its four co-sponsors proposed the immediate initiation of a solution-focused process allowing for targeted

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20 Communication from Honduras, *Fostering a Discussion on the Functioning of the AB: Addressing the Issue of Alleged Judicial Activism by the AB*, WT/GC/W/760 (Feb. 4, 2019).
discussions between interested Members.\textsuperscript{21} The authors support this idea. WTO Members should review and discuss the matter without prejudice.

(iii) Reinforcing Independence of the AB

The other communication submitted by the EU, co-sponsored by China and India, contains more ambitious proposals; (a) independence of AB members, (b) efficiency and capacity to deliver, (c) transitional rules for outgoing AB members, and (d) the launch of the AB selection process.\textsuperscript{22} All of these are the attempts to reinforce independence and autonomy of the AB.

For certain G20 economies, these proposals would be difficult to accept. While we should be cautious about unduly strengthening political control over the AB in line with the allegations critical of the AB, the authors do not think it appropriate to give the AB more autonomy than it now enjoys. The authors believe that it would not assist in solving the current problems that the DSM faces. To the contrary, it could enlarge discrepancies between WTO Members’ positions on this issue. Therefore, the authors do not endorse these proposals.

(iv) Mobilizing Stakeholders

As the authors explained above, the most important contribution of the WTO DSM is to ensure security and predictability in the world trading system. There is no doubt that the ultimate beneficiaries of the contribution are business societies acting in the global market because the WTO DSM sustains the environment for their international business by underpinning the making and implementation of commitments. Therefore, the Authors believe that progress is not possible without mobilizing these stakeholders in the discussion of the

\textsuperscript{21} Communication from Australia, Singapore, Costa Rica, Canada and Switzerland to the General Council, \textit{Adjudicative Bodies: Adding to or Diminishing Rights or Obligation under the WTO Agreement}, WT/GC/W/754/Rev.2 (Dec. 11, 2018).

\textsuperscript{22} Communication from the European Union, China and India to the General Council, WT/GC/W/753 (Nov. 26, 2018).
WTO DSM and the AB. The technical discussion as has been developed in Geneva is necessary but is not sufficient.

For that purpose, the Authors urge the G20 leaders to actively listen to voices from these stakeholders, and closely cooperate with B20 to tackle the problem. It is also recommendable for the leaders to have a dialogue with other fora composed by business leaders, for example, APEC Business Advisory Council (ABAC), which recently emphasized that the integrity of the rule-based WTO trading system including the WTO DSM must be respected.23

2. Alternative Approaches: What if the deadlock remains?

Background

So far, we have discussed policy options to reform the WTO DSM, focusing on the AB procedures. If WTO Members were to agree on them, the current AB crisis would be resolved. But we should also think of a worst case scenario, where WTO Members cannot reach agreement on how to reform the WTO DSM, or at least not in a timely manner that averts the AB ceasing to function.

Art. 25 Arbitration

One option under this worst case scenario is to resort to ADR under DSU article 25 in lieu of appeal.24 WTO Members may have recourse to arbitration in accordance with DSU article 25, and arbitration awards may be enforced. However, arbitration is only an alternative means of dispute resolution. The disputing WTO Members may choose to submit to arbitration certain issues raised in a panel report when one (or all) of them disagree on how the panel resolved them. However, this would not constitute an appeal under the terms of the DSU. This is not mere semantics. In legal proceedings, obviously legal

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issues matter. Disputing parties in a WTO case may choose to submit to arbitration issues that one of them would have otherwise wanted to appeal, and thereby decline to appeal them. But agreeing to submit those issues to arbitration does not transform arbitration into an appeal process and an arbitration tribunal into an appellate body.

Therefore, if WTO Members are unable to agree to appoint new AB members, that impasse will effectively block the operation of the dispute settlement system for some disputes, and, more likely, for many. Indeed, there will be some Members who will decide not to participate in any alternative solution, whether it is having recourse to DSU article 25 arbitration or any other. It is also quite likely that some Members may accept an alternative solution for some disputes, but they may deem the issues involved too important to their respective interests to waive their right to appeal in other disputes.

The absence of a functioning AB will give some WTO Members the ability to block the adoption of dispute settlement reports, which may not necessarily be unreasonable or amount to obstruction. Indeed, the underlying motives may be quite legitimate.

In any event, DSU article 16.4 provides that panel reports shall be adopted by the DSB “unless a party to the dispute formally notifies the DSB of its decision to appeal or the DSB decides by consensus not to adopt the report”. It then adds that “[i]f a party has notified its decision to appeal, the report by the panel shall not be considered for adoption by the DSB until after completion of the appeal”. Thus, in the absence of a functioning AB, if a disputing party in a WTO case declines to participate in an alternative solution and files a notice of appeal with the DSB, those proceedings would be blocked.

Does this mean, therefore, that a WTO Member that alleges that another Member has breached its obligations under the WTO would not get redress?

**Countermeasures under general international law**

If the DSM were to cease to operate, the WTO Agreements do not provide other
means of ensuring that the balance of rights and obligations of WTO Members can be preserved. General international law, however, provides a means of redress if that were to be the case, through the use of countermeasures.

Countermeasures are measures that a State that has been injured by the wrongful act of another State (the responsible State) may take to vindicate its “rights and to restore the legal relationship with the responsible State which has been ruptured by that internationally wrongful act”.\textsuperscript{25} Countermeasures may be taken by an injured State against the responsible State, in order to induce the latter to comply with its international obligations or otherwise reach a mutually acceptable solution. They are temporary because they must be withdrawn once the internationally wrongful act has ceased, and they must be commensurate to the injury suffered. The ILC Articles on State Responsibility provide:

\textbf{Article 49. Object and limits of countermeasures}

1. An injured State may only take countermeasures against a State which is responsible for an internationally wrongful act in order to induce that State to comply with its obligations under Part Two.

2. Countermeasures are limited to the non-performance for the time being of international obligations of the State taking the measures towards the responsible State.

3. Countermeasures shall, as far as possible, be taken in such a way as to permit the resumption of performance of the obligations in question.

[...]

\textsuperscript{25} ILC Articles on State Responsibility, Commentary to Part Three, Chapter II, para.(1), p. 324
Countermeasures are not foreign to the WTO. Indeed, the provisions on suspension of concessions regulate the use of countermeasures in the WTO framework. Under the DSU, concessions cannot be suspended unless the DSB has authorized it, and that can only happen after: (a) a panel or an AB report has been adopted; (b) the WTO Member that adopted the offending measures (i.e. the “responsible State”) has been given an opportunity to conform those measures to the recommendations of the DSB; and (c) it has failed to do so. However, where that cannot be achieved because a report cannot be adopted due to the AB being unable to function (or there being no AB at all), public international law would not preclude resort to countermeasures in order to restore the balance between Members’ rights and obligations. In other words, a WTO Member would not be free to breach its WTO obligations without consequence simply because the dispute settlement system is not fully functional.

The US, for instance, has advocated this position, albeit in the framework of the 1947 GATT and the Tokyo Round Codes, where the GATT Contracting Parties were able to block the operation of the dispute settlement process through the positive consensus rule. In 1985, the US increased import duties on certain products from the then European Economic Communities (EEC) in response to

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26 Mavroidis argues that “Article 23(2) DSU imposes an unambiguous obligation on all WTO members to submit their disputes to WTO panels; as a consequence, countermeasures remain an option in the WTO only to the extent that they are multilaterally authorized by the WTO” (footnote omitted). He assumes, though, that the dispute settlement mechanism is fully functional. Mavroidis admits that the WTO agreements are not a self-contained regime that is isolated from general international law, and that “[t]o the extent, consequently, that the WTO regime does not provide for specific remedies, the ILC codification [i.e. the ILC Articles on State Responsibility] is relevant.” Mavroidis (2000), pp. 765–766. That would be the case if the AB were to cease to operate: there would no longer be a specific remedy and recourse to countermeasures would not be precluded.
discriminatory tariffs granted by the EEC to certain Mediterranean countries that affected US citrus exports and, the US claimed, were illegal under the GATT 1947. Upon proclamation of the increased duties, the US declared: “This action has been necessitated by the unwillingness of the EEC to negotiate a mutually acceptable resolution of this issue”.27

Moreover, at a GATT Council meeting in 1989, the US insisted on its right to take such action when another GATT Contracting Party impeded the operation of the GATT dispute settlement mechanism:

Wherever it could, the United States would challenge unfair practices under the dispute settlement provisions of the General Agreement or the Tokyo Round Codes, but where other contracting parties prevented or impeded that process or blocked efforts to ensure that their practices were covered by multilateral disciplines, the United States would act to protect its interests. If such action was considered unilateral, it should be nevertheless recognized as perfectly justifiable, responsive action necessitated by the failure of bilateral or multilateral efforts to address a problem.

(GATT document C/163, March 16, 1989, p.4.)

Countermeasures, however, should be used sparingly, judiciously and with restraint. As the Air Services Tribunal put it, countermeasures should be a wager on the wisdom, not on the weakness of the other Party:

It goes without saying that recourse to counter-measures involves the great risk of giving rise, in turn, to a further reaction, thereby causing an escalation which will lead to a worsening of the conflict. Counter-measures therefore should be a wager on the wisdom, not the weakness of the other Party. They should be used with a spirit of great moderation and be accompanied by a

genuine effort at resolving the dispute...


Thus, WTO Members should be mindful of not provoking an escalation of the dispute or to increasing trade tensions by resorting to countermeasures.

The right to resort to countermeasures cannot serve as an excuse to circumvent the dispute settlement procedure. For instance, if the AB ceases to be able to operate, and it is clear that there would be no possibility of appeal in a given case, this would not excuse a Member from submitting to dispute settlement nor justify resorting directly to countermeasures instead. The Air Services Tribunal noted that “[u]nder the rules of present-day international law, and unless the contrary results from special obligations arising under particular treaties, notably from mechanism created within the framework of international organisations, each State establishes for itself its legal situation vis-à-vis other States” (Id., p. 443, ¶ 81).

Article 23 of the DSU precludes any WTO Member from making a determination to the effect that a violation has occurred, that benefits have been nullified or impaired or that the attainment of any objective of the covered agreements has been impeded, except through recourse to dispute settlement in accordance with the rules and procedures of the DSU. It requires, as well, that any such determination be consistent with the findings contained in the panel or AB report adopted by the DSB or an arbitration award rendered under the DSU. However, while the DSU regulates countermeasures within the WTO framework, WTO Members have not waived their right to resort to such measures.

By the same token, the right to use countermeasures under international law does not render the provisions of the DSU inapplicable or even irrelevant. First, while general international law provides a remedy to WTO Members through the use of countermeasures if the AB were to become unavailable, it would not otherwise affect WTO Members’ rights and obligations under the WTO Agreements, including the DSU, which would remain in force. Indeed, Article 50(2) of the ILC Articles on State Responsibility specifically provides that a
State taking countermeasures is not relieved from fulfilling its obligations under any dispute settlement procedure applicable between it and the responsible State, and the DSM would still be available and largely functional. The Commentary to the ILC Articles of State Responsibility makes this very point: “It is a well-established principle that dispute settlement provisions must be upheld notwithstanding that they are contained in a treaty which is at the heart of the dispute and the continued validity or effect of which is challenged”.28

Of course, securing a positive solution to the dispute could still be achieved (DSU Article 3.7). In fact, the DSU gives preference to a mutually acceptable solution that is consistent with the covered agreements over any other solution, including compliance with adopted reports (Id.). That solution may be found at any time during the dispute settlement proceedings. The disputing parties may be satisfied with the panel report and decide not to appeal. Of course, dispute settlement procedures take time and the appointments may be resolved before the dispute gets to the appeal stage. Thus, an injured WTO Member would be under a continued obligation to submit to dispute settlement under the DSU, and to advance the process as far as possible before imposing countermeasures.

The GATT 1994 and, more specifically, the DSU are also relevant to the question of proportionality. Building on GATT 1994 Article XXIII:2, DSU art. 22.3 establishes the principles and procedures to be followed in determining what concessions or other obligations a WTO Member may suspend.29 These principles and procedures would continue to apply pursuant to Article 50(2) of the ILC Articles on State Responsibility.

A question arises as to whether a dispute settlement panel would accept recourse to international countermeasures as valid in the WTO framework in the circumstances described in this Policy Brief, if the country whose measures were originally found by a WTO panel to be inconsistent with the covered agreements was to take countermeasures in the circumstances described.

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28 ILC Articles on State Responsibility, Commentary to Article 50, para. (13), p.338.
29 “Suspension of concessions or other obligations” is the language used by the DSU to refer to international countermeasures, in their regulated form within the WTO framework.
agreements were to challenge, in turn, the countermeasures before another WTO panel. That international countermeasures are a legitimate defense under general international law is well established. The difficult question for a WTO panel to decide is whether a WTO panel is confined to the four corners of the WTO Agreements and cannot consider other questions of general international law beyond the customary rules of interpretation of public international law (DSU art. 3.2).

In the authors’ view, it would not be so constrained. WTO law is, of course, not isolated from the rest of public international law. The AB has recognized that “WTO panels have certain powers that are inherent in their adjudicative function” and “that panels have "a margin of discretion to deal, always in accordance with due process, with specific situations that may arise in a particular case and that are not explicitly regulated"”. However, if it were to find that international countermeasures are WTO inconsistent, even in the circumstances where a breach of the WTO Agreements has been found, the offending measures remain in effect and the dispute settlement mechanism has been blocked, the WTO Member that imposed countermeasures notify to the DSB its decision to appeal the report and the proceeding would be equally blocked. Hopefully, as noted above, both Members concerned would act judiciously and with restraint, and there would be no further escalation of the matter, especially since a new balance – albeit not nearly an ideal one - would have been struck. It is to be noted that a similar situation could have been brought before a GATT 1947 panel, but it was not. Where the GATT Contracting Parties resorted to these types of measures during the GATT 1947 days, the matters were ultimately resolved and did not escalate further. If it comes to that in future, hopefully the outcome would be no different.

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TRADE, INVESTMENT AND GLOBALIZATION

The Digital Economy for Economic Development: Free Flow of Data and Supporting Policies*

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Abstract

The digital economy provides ample opportunities for G20 economies to accelerate inclusive economic growth. To take advantage of digital technology, free flow of data backed up by a series of policies to address other public policy objectives must be promoted. However, policies for the flow of data and data-related businesses are still underdeveloped and fragmented across countries. Nevertheless, although ample controversy exists, G20 economies must design and implement a series of policies as soon as possible. We will show in this policy brief that standard microeconomic theory can provide guidance to formulate such policies.
Challenge

Digital technology has two faces: information technology (IT) and communication technology (CT\(^1\)). IT represented by artificial intelligence (AI), robotics, and machine learning speeds up data processing, reduces the number of tasks, and generates concentration forces for economic activities. On the other hand, CT such as the internet and smartphones overcomes distance, makes communication and matching easier, encourages the division of labor, and yields dispersion forces. From the viewpoint of newly developed and developing countries, while the application of IT must be tried, the immediate focus must be placed on CT.

The wave of CT has already arrived. Thanks to a drastic cost reduction in business-to-consumer (B-to-C) and consumer-to-consumer (C-to-C) matching, internet platforms and digital businesses have been mushrooming, including social media, e-commerce, net-assisted transportation, matching services in lodging, e-payments, and fintech. We foresee the emergence of cross-border service outsourcing or the third unbundling (Baldwin 2016). The usage of CT will also have strong implications for inclusiveness stipulated in the Sustainable Development Goals. Although platform providers require high-level human resources, platform users do not have to meet high skill qualifications. CT provides easier access to information, communication, and economic opportunities for a wide range of people.

However, the policy regime for the governance of data is only at a nascent stage; it is underdeveloped and fragmented across countries. A fundamental problem is that the logic of economic justification for policies is not well established. Policies related to data flows and data-related businesses are overseen by various ministries and agencies, and coordination is often minimal.

There is a predecessor from which we can learn, i.e., free trade in goods. There are four kinds of policies that support free trade in goods. The first is policy that liberalizes and facilitates trade. Simple tariff removal is not enough to realize

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\(^1\) Aghion, et al. (2014) initially proposed the concept of IT and CT in the context of intra-firm governance. Then, Baldwin (2016) applied the concept for the international division of labor.
the smooth flow of goods. We need the removal of redundant non-tariff measures, the liberalization of trade-related services, and trade facilitation. The second is policy that corrects or cancels out distortion due to market failure. Market failure comes from the existence of externalities, the existence of public goods, economies of scale, imperfect competition, and incomplete information. We must identify where a market failure exists and apply appropriate policy, preferably the first-best policy. The third is policy that reconciles other value judgments with economic efficiency. GATT Article XX General Exceptions takes care of values such as public morals, life and health of humans, animals, and plants, and the protection of national treasures. The article specifies what sorts of exceptions are allowed and requests member countries to apply least trade-restrictive measures. The fourth is policy that incorporates imported goods and trade activities within the domestic policy regime. An example is the border tax in the European Union (EU), which is intended to adjust for the value added tax imposed on domestic producers.

Proposal

This policy brief suggests that a systematic formation of policies for the flow of data and data-related businesses can be developed based on an analogy with trade in goods. On this basis, the brief classifies a series of data-related policies based on the standard microeconomic theory and provides a starting point for policy making.

1. Free flow of data and the justification for government policies

Drawing an analogy from free trade in goods, we set “free flow of data” based on the standard microeconomic theory as a starting point. The benchmark model is the microeconomic model under perfect competition in which the laissez-faire economy achieves the Pareto efficient equilibrium. The implication is that without market failure, the economy can achieve the highest welfare. There is a presumption that free flow is consistent with optimal outcomes.
Public policy intervention is justified if one of the following conditions holds:

(i) Further policy effort for liberalization and facilitation is required.

(ii) Market failure due to the existence of externalities, the existence of public goods, economies of scale, imperfect competition, or incomplete/asymmetric information is found, and a policy to correct or cancel out market distortion can be effective.

(iii) Important values or social concerns other than economic efficiency such as privacy protection, public morals, human health, or national security exist.

(iv) Policies are needed in order to accommodate data flows and new data-related businesses in the domestic policy regime.

In the following, a series of policies on data flows and data-related businesses will be listed along these four categories.

2. Policies for liberalization and facilitation

The flow of data is by nature almost frictionless, regardless of national borders. Once the internet connects us, data moves freely unless governments impose restrictions.

However, there is still room for further liberalizing and facilitating the flow of data and data-related transactions. The following is a list of policies discussed in the WTO and other international forums, or covered by measures in regional trade agreements.

(i) Non-discrimination for digital content

The non-discrimination principle, i.e., the most-favored-nations (MFN) and the national treatment (NT) principle, must be applied for digital content. There is still some discussion on the definition of digital content as well as the coverage of the existing principle in the WTO, particularly GATS.
(ii) Customs duties on electronic transmissions

At the Second WTO Ministerial Meeting in 1998, the WTO members agreed to the “Ministerial Declaration on Global Electronic Commerce,” that promised to maintain the practice of not imposing customs duties on electronic transmissions. The moratorium has been extended since then.

(iii) Customs duties on parcels: *de minimis*

The moratorium still allows tariff imposition on goods that move across national borders. Thus, small parcels by e-commerce are subject to tariffs. There is an economic argument claiming that exempting *de minimis* - i.e., low-valued parcels - from tariffs and possibly other taxes, could help cross-border e-commerce to expand, particularly for small businesses (Hufbauer and Wong 2011, Suominen 2017).

(iv) Electronic authentication and electronic signatures

These make not only e-commerce but also various remote transactions quick and efficient. International cooperation is needed to support cross-border commercial activities.

### 3. Policies to correct or cancel out market failure

The digital economy has built-in potential for market failure, given that big data gives rise to network externalities, economies of scale and scope, and pervasive information asymmetry. Each of these conditions individually can result in market failure; combined, they create a strong likelihood that problems will emerge.\(^2\) Indeed, even in the early years of this emerging economy, examples have surfaced as the technology giants have been censured for abuse of

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\(^2\) Ciuriak (2018a) refers to the new economic growth theory for the knowledge-based economy and emphasizes the seriousness of the potential for market failure in the data-driven economy.
dominance, ethical failures in exploiting private information, tax avoidance, leveraging their size to extract public subsidies, and pre-emptive takeovers of potential future competitors. As individual governments react to specific instances with policy remedies, the design of effective and globally coherent distortion-canceling policies thus become imperative.

(1) Competition policy

The powerful forces for concentration inherent in the characteristics of the data-driven economy are already evident in the growing concentration within the industry (The Economist, 2016); and, as noted, specific instances of abuse have been identified and countermeasures taken. Some degree of caution is, however, necessary in applying competition policy remedies. In theory, market distortion is generated by the abuse of market power rather than by market concentration per se. Furthermore, even in a case of monopoly, serious market distortions may not arise if the market remains contestable – i.e., if the possibility of competitive entry remains open to discipline the behavior of the incumbent dominant firms. The speed of technological progress is an important consideration in the latter regard as new business models may disrupt established dominant market positions.

Nonetheless, many countries have concerns, in particular about the giant platform companies (GAFA: Google, Amazon.com, Facebook, Apple Inc.; and BAT: Baidu, Alibaba, Tencent), given their dominance in big data usage, possibly unfair trade practices, and moves to swallow potential future rivals (e.g., Facebook acquiring Whatsapp). The merger of Uber and Grab in their

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3 Google has been found guilty by Germany’s competition authority of abuse of its dominance to favour its affiliated companies. European Commission (2018).
4 Facebook has been censured for ethical breaches as well as abuse of dominance by the UK House of Commons’ Digital, Culture, Media and Sport Committee (House of Commons, 2019).
7 Solomon (2016).
8 For example, in 2017, Germany introduced a major reform of its competition law with the aim of creating a “regulatory framework for the digital economy”. Freshfields Bruckhaus Deringer LLP (2018).
transport operations in Southeast Asian countries was also regarded as a possible factor for reducing competition. And the use of data to implement price discrimination practices to capture consumer surplus for corporate profits also has welfare implications since this tends to increase income disparities.

Generally, a substantially strengthened competition policy at the international level appears to be called for to correct or cancel out market distortion in the data-driven economy. At the same time, recognizing that competition policy activism can be motivated by protectionism, multilateral rules are needed to prevent trade frictions from emerging from differing interpretations of whether abuses of market dominance were in fact in evidence, and they must stipulate the appropriate remedies (e.g., whether market dominance should be corrected by mandatory sharing of data with competitors, for example).

(2) Consumer protection

Transactions between businesses and consumers tend to be characterized by asymmetric information; sellers are typically much more knowledgable regarding goods and services they sell than buyers. In addition, once a problem occurs, businesses are in an advantageous position compared to individual consumers in dealing with the consequences. Such market failure is potentially more frequent and serious in e-commerce than with physical transactions and more difficult to remedy in cross-border e-commerce than in a domestic market context, not least because novel forms are enabled by exploitation of data – for example, websites tracking customers’ surfing history can “personalize” prices, substantially expanding the scope for first degree price discrimination (Hannak et al., 2014; Mahdawi, 2016).

Market solutions can actually do much to resolve these concerns. For example, the “market for lemons” (Akerlof, 1970) illustrates how market mechanisms emerge to address problems of asymmetric information. Modern examples of such market responses include consumer rating systems on eBay and consumer grievance desks.
Nonetheless, to make consumers feel safe, to optimize welfare gains, and to encourage online markets to expand, there may be a role for government to intervene to protect consumers, including by monitoring the performance of market mechanisms. UNCTAD\(^9\) indicates that only 51% of the countries in the world have online consumer protection legislation and 33% of the countries provide no data. The quality of the legal arrangements as well as their implementation also differ widely. Accordingly, there appears to be room for broader adoption of best practices in this area.

As for cross-border e-commerce, international cooperation and coordination are certainly needed. OECD (2016, 2018) is a good starting point for constructing a system of consumer protection. The EU has a series of policies for cross-border e-commerce under the umbrella of the Regulation on Consumer Protection Cooperation including online dispute resolution, alternative dispute resolution for consumers, European Consumer Centres Network, and European small claims procedure.\(^10\)

(3) Intellectual property rights (IPR) protection

The digital transformation raises both conventional issues related to IPR (the protection of IPR is foundational to knowledge-based business models) and novel ones related to data: e.g., the patentability of databases, ownership of data, secrecy of algorithms and source code (especially when these are used in ways which have legal consequences, such as determining eligibility for parole on grounds of likelihood of recidivism, etc.), and the expansion of the realm of trade secrets generally (e.g., new EU and US laws expanding the ambit of trade secrecy laws).

Alongside these issues related to supporting commercialization of data are new concerns about competitive access to data and even more fundamentally the

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suitability of traditional measures for incentivizing production of IP (patents and copyright) when IP can now be produced at a massive scale by AI.

Finally, because of different national circumstances and optimal policy choices, IPR protection is uneven across countries. The gap is becoming even larger with the digital divide.

TRIPs in the WTO is not obviously enough to protect IPR, particularly in the digital era.\(^\text{11}\) CPTPP tries to strengthen IPR protection, though some criticism exists concerning its implementability. The EU considers its intellectual property law as a benchmark for international harmonization.\(^\text{12}\) The Anti-Counterfeiting Trade Agreement (ACTA) was a trial on a plurilateral basis and was signed by eight countries in October 2011. However, it has so far failed to be validated due to the missing ratification of six countries. CIGI and Chatham House (2017) provide a collection of insightful policy papers on IPR protection in the digital era.

4. **Policies to reconcile values and social concerns with economic efficiency**

(1) Data and privacy protection

Privacy protection has become the most prominent concern in the digital economy; indeed, given the ubiquity of both state and corporate surveillance, the issues have even been regarded as touching on basic human rights. Policies must be designed so as to reconcile these values with economic efficiency.

UNCTAD \(^\text{13}\) warns that many newly developed and developing countries have not yet established formal legal protection. The boundaries of privacy protection and the scope of data localization differ widely across countries (Hodson 2018, Sen 2018). In particular, the three major data “realms” - the US, the EU, and China – have constructed quite different data protection regimes

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11 See for example Aaronson (2018).
(Aaronson and Leblond 2018). Without a substantive effort for harmonizing the regulatory regimes, the digital world may become segmented.

The General Data Protection Regulation (GDPR) in the EU is currently the most advanced policy for protecting private data. It clearly defines “personal data” and the rights of citizens and shows what and how the GDPR governs. The EU imposes strong data localization requirements for personal data and establishes adequacy conditions under which cross-border data exchanges are allowed with third countries. Criticisms of the GDPR focus on compliance costs borne by the business sector, a risk of degrading services for consumers, and stifling of innovation.

Another effort is found in the APEC Cross-border Privacy Rules (CBPR) System, which is a voluntary, accountability-based system that facilitates privacy-respecting data flows among APEC economies. So far, eight economies (the US, Mexico, Japan, Canada, Singapore, the Republic of Korea, Australia, and Chinese Taipei) have joined the system.

Mattoo and Meltzer (2018) pursue a desirable international policy framework by comparing the existing three types of policies to reconcile the free flow of data and privacy protection: unilateral development of national or regional regulation such as GDPR, international negotiation of trade disciplines such as CPTPP, and international cooperation involving regulators such as the EU-US Privacy Shield Agreement.

Data protection issues have expanded beyond personal data. Massive business-related and other data including from Internet of Things (IoT) sources are starting to move across national borders. Redundant restrictions must be avoided.

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15 See for example Yaraghi (2018). Ferracane, Kren, and van der Marel (2018) attempt to quantify the cost of data restrictions on the productivity of firms across countries.
17 Not limited to the argument pertaining to privacy protection, Gao (2018) and Mitchell and Mishra (2018) seek possibilities of reconciling different regulatory systems under the umbrella of the WTO.
(2) Cybersecurity

Cybersecurity is one of the prime concerns for both the government and the private sector. Some countries, based on national security reasons, require disclosure of source code as condition for market access and/or “backdoor access” to proprietary and encrypted data, which creates risk of IPR leakage for companies.18

A portion of the cybersecurity issues relate specifically to critical national security interests; and given the international security divides, worldwide cooperation in depth may be inherently difficult to achieve, although a reasonable détente is an important goal to aim for.19 It will be highly important for some international norms to be established and implemented. Another aspect of cybersecurity, cross-border cyber-attacks on both government agencies and private companies for example, requires international collaboration for preparing and implementing counter-measures.

Some express a concern that various regulations that are imposed in the name of cybersecurity are in fact hidden forms of protectionism.20 The purpose of policies must be clarified, and the mechanism should be transparent in order to avoid erosion of legitimate market competition.

Although perfect harmonization of cybersecurity systems is difficult, there is ample room for international cooperation on policy making. The OECD has

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18 Moran (2015) reviews the cases of the compliance by IBM and Microsoft in the disclosure of source code in China. Meanwhile, the Reform Government Surveillance (RGS) group, which includes the major Internet corporations Apple, Google, Facebook, Microsoft, Oath, LinkedIn, Dropbox, Evernote, Snap, and Twitter, have been fighting against demands by the “Five Eyes” governments for backdoor access to proprietary and encrypted information in their networks. See, e.g., Owen (2018). Companies emphasize that backdoors for one create security weaknesses for others.

19 Ciuriak (2018c).

developed an extensive program for the stocktaking of policies and the provision of policy guidelines.  

Finding a proper level of cybersecurity regulation has been a challenge. Overregulation would interfere with economic dynamism. Underregulation leaves parties open to cyber-attacks. In addition, although the government may want to keep room for policy discretion, gaps between legal arrangements and enforcement could also generate anti-business uncertainties.

(3) Other general exceptions

Other general exceptions may be considered in parallel with GATT XX. Public morals as well as human, animal, or plant life or health are natural concerns. Furthermore, culture and non-discrimination in race or gender may be the issues to take care of. Achieving these goals while minimizing barriers to trade is a challenge as always.

5. Policies to accommodate data flows and data-related businesses in the domestic policy regime

(1) Taxation

Data-related businesses are new, dynamic, and international. How to incorporate them in the existing domestic policy regime is a big challenge. One of the controversial issues is taxation.

One issue is on value added taxes (VAT). Many countries apply VAT that are collected from sellers. There is thus an argument that domestic service providers may become disadvantageous compared with foreign service providers through the internet who are not subject to such taxes in importing countries. On this issue, many countries have followed the recommendations

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21 See for example OECD (2012).
provided by BEPS Action 1 on Digital Economy and have implemented a mechanism for collecting VAT on services acquired by private consumers from non-resident suppliers/sellers (if possible) or from the consumers on payment, due to the fact that most of such payments are handled by a small number of actors in the financial sector.

Another, more controversial issue is corporate income taxes. The traditional norm is that mode 1 (cross-border) service providers are treated like goods exporters and thus pay corporate income taxes in the home country, not in export-destination countries. However, where giant international platformers earn profits is not very clear. How they design and operate value chains is not often publicized in detail. There is concern regarding their tax arbitrage practices that take advantage of tax rate differences across countries to avoid tax payments. People also worry about a possible disadvantageous position of domestic platformers who pay corporate income taxes in full versus giant platformers who may not pay much. To address such concerns, discussions were held under the Inclusive Framework on BEPS in order to find a coordinated solution to this issue. At the same time, a number of countries have started introducing or considering so-called “interim measures” to tax digital services on foreign platformers, often in the form of taxation on the amount of sales, under the belief that it is imperative to act quickly.

The logic of interim measures is partially understandable, but controversial. Economically, such taxes have an effect similar to the case of trade in goods where a tariff is imposed discriminatorily on specific exporters. How can a county identify the tax owing parties and their appropriate level of taxation? The debate surrounding these issues is significant.

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24 As proposed by RIGONI (2000), XXX Jornadas Tributarias CGCE, Argentina, p.67.
There should be no specific taxation on the digital economy. It should be taxed as any other activity in order not to diminish the free flows in commerce. As recommended previously, harmonized nexus and profit allocation concepts should be applied, in line with the exigencies of digitalization. Ultimately, as more and more economic activity shifts online, the imperative of technological neutrality in applying taxes will become more urgent.

(2) E-payments, fintech, and other industrial regulations

E-payments are flourishing in many newly developed and developing countries and are reducing transactions costs, sometimes as a strong substitute to traditional payment systems. The underlying technological progress in biometric authentication, machine learning, blockchains, online credit scoring, and peer-to-peer (P2P) financing are among the global trends of fintech development. How to incorporate these new digital services into the system of monetary and financial regulations is an urgent topic.

The licensing system or safety standards for transportation services, lodging services, and others is another issue for how to incorporate new digital services into the traditional regulatory framework.

(3) AI

Incorporating new technologies into our economy and society is always a big challenge. One important topic is AI.

The OECD Committee on Digital Economy Policy established an Expert Group on Artificial Intelligence in Society (AIGO) in May, 2018, to scope principles for public policy and international cooperation. The currently proposed Guidelines for AI include five principles: inclusive and sustainable growth and well-being,

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26 T20 Argentina, “Tax Competition” (https://t20argentina.org/publicacion/tax-competition/).
human-centered values and fairness, transparency and explainability, robustness and safety, and accountability.27

(4) Information disclosure of firms and statistics

A fundamental issue is that the information on the activities of giant international platformers is not well disclosed. Outsiders have little capacity to understand how they organize and operate their activities domestically and internationally, where they have servers to store the data, and how they make profits. These problems have created a series of concerns on international digital businesses, particularly in the context of competition policy, taxation, and statistics. A possible remedy would be to introduce a system of information disclosure for their activities.

(5) Due process in government access to privacy/industry data

Another concern in the digital economy is how and to what extent the government can gain access to private or industry data. In many countries, the police can only enter a private company or residence to investigate through proper legal due process provided for in their judicial system. In the cyberspace, however, such rules seem to be blurred. At some point in time, we may need to introduce a proper due process for government intervention.

6. Industrial Policy and Strategic Trade and Investment Policies

Against the background of the above considerations regarding the governance of data, perhaps the most difficult issue facing the G20 is that of strategic trade and investment policy incentivised by the rents available in the international domain in the data-driven economy. Genuinely new infant industries – or,  

better, new disruptive business models – are emerging everywhere in the IoT domain. All the major jurisdictions are investing heavily to secure their foothold and gain competitive advantage. This is not necessarily a bad thing: the rationale for public investment in this domain is strong given the high risks involved, the rapidity of technological change which shortens the horizon for recovery of investments, and the potential social benefits of new technologies, which may far exceed private returns.

However as in prior instances when new technologies created such opportunities, the strategic trade and investment policy are leading to outright trade war. While the main action has been between the major technological powers, and in particular between the United States and China, it is natural for newly developed and developing economies to also consider the possibility of nurturing their own industries behind digital firewalls, with national e-commerce strategies. However, is it economically justifiable?

We can apply standard argument on infant industry protection even in the case of data-related businesses. First, check whether the industry will be internationally competitive at the end (Mill's criterion). Second, check whether the time-discounted future benefits would be larger than the time-discounted costs (Bastable's criterion). Then verify whether the government intervention is essential; the test of the existence of externalities.

One thing that we must consider is the benefit that small businesses and consumers obtain from “free” internet services. In addition, the speed of technological progress is so fast that a country may not catch up without introducing foreign services providers. Furthermore, a small country may not be in a position to fully utilize network externalities. Therefore, logically, for most small economies, the early liberalization of digital-related businesses is likely to be a better option than protecting infant domestic players.

At the same time, it is imperative that the digital divide not result in new forms of the middle income trap emerging and developing countries becoming simply rent payers to advanced country firms that have acquired dominant positions in the new digital economy.
Although data localization requirements are introduced for various reasons such as privacy protection, cybersecurity, and taxation, one of the hidden motivations tends to be the protection of domestic industries. Policy purposes must be clarified, and careful assessment is necessary. At some point in time, we should develop a multilateral system of stocktaking protective measures for the flow of data and data-related businesses.

7. The path forward

The establishment of an efficient supporting policy regime for the digital economy is urgent, particularly for newly developed and developing countries. To set a “free flow of data” as a default is a useful approach to examine supporting policies in a systematic manner. The system of policies for the flow of data and data-related businesses must be neither too weak nor too strong. G20 may want to undertake a comprehensive stocktaking of policies related to data flows and data-related businesses.

The launch of new talks on new e-commerce rules in the WTO is certainly good news, which G20 may want to support. However, considering the level of preparedness in supporting policies in other countries, a country may want to be selective in choosing its foreign counterparts. Ideally, we would like to establish a holistic multilateral framework, but it is likely that this will take time. Newly developed and developing countries may need to find a way to undergo liberalization quickly in order to enjoy the benefits from the digital economy and enhance international competitiveness.

The internet has vigorously developed as a private, decentralized initiative, rather than following a top-down approach by governments. Smartphones and CT also have strong characteristics of inclusiveness and have wide-ranging effects for various stakeholders. Thus, in the coming domestic and international rule-making for the flow of data and data-related businesses, we need to apply

28 As for various forms of data localization requirements, see Cory (2017).
29 Ciuriak (2018b) presents the nature of challenges that developing countries would face in their efforts to formulate data governance.
a multi-stakeholder approach including private companies, academics, and civil society.

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Services Trade for Sustainable, Balanced, and Inclusive Growth

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Abstract

Structural changes in the world economy have altered the way we think about the nexus between trade and growth. In particular, the rise of the services economy and the digital revolution have rocked the world of trade policy-making in ways that are not nearly sufficiently reflected yet in international economic policy forums like the G20. Therefore, this policy brief urges G20 policy-makers to pay greater attention to trade in services and its crucial role in achieving the G20 objectives. Strong, sustainable and inclusive growth will not be achieved without due consideration of services.

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1 The views expressed in the Brief are those of its co-authors in their personal capacity and not those of the institutions to which they are affiliated. The authors acknowledge comments from Richard Baldwin, Professor at the Graduate Institute of international and Development Studies, and Martin Roy, Counsellor at the WTO Trade in Services and Investment Division. All errors remain our own.
Challenge

Ten years after the 2009 Pittsburgh Summit, key items of the G20’s Strong, Sustainable and Inclusive Growth (SSIG) agenda remain unfulfilled. Major objectives of that agenda have stalled, as progress towards more balanced, sustainable and inclusive growth remains elusive (IMF, 2018).

Services have revolutionized the trade landscape

Meanwhile, structural changes in the world economy have altered the way we think about the nexus between trade and growth. While industrial development has played a key role in export-led development trajectories in the past, the modern globalised economy offers much broader, often overlooked possibilities. In particular, the rise of global value chains and the emergence of trade in services have challenged long-held tenets about international trade and its way of driving economic progress. ICT-enabled services in particular offer potential for export diversification that defy the logic of traditional paradigms by relying purely on electronic cross-border delivery, making it accessible even to countries with underdeveloped physical trade infrastructure (eg. Roy, 2017).

In recent years, global exports in manufactured goods as a percentage of GDP have plateaued and even declined by 1.2 percentage points between 2007 and 2017, whereas trade in services has increased its share in GDP (McKinsey, 2019). Most of the growth in services trade is in high value-added and high-productivity sectors such as in ICT and various business services. The services sector is now the dominant destination of FDI flows accounting for roughly two thirds of the global FDI stock, up from less than 50% in 1990 (Roy, 2019).

Policies do not take sufficient account of these revolutions

Against the backdrop of mounting international trade and investment tensions and of calls by WTO members to “de-escalate the situation” (WTO, 2018a), this Policy Brief will argue that policy-makers need to pay greater attention to trade in services and its crucial role in achieving the G20 objectives. Strong, sustainable and inclusive growth will not be achieved without due consideration of services. The need to focus more on trade in services will
become increasingly important in the near future as a result of technological changes – notably automation, additive manufacturing, internet of things, machine learning and artificial intelligence applications. The so-called Globalization 4.0 will have major impacts, both positive and negative, on national labor markets and services jobs in particular, a sector that has hitherto been relatively spared from the forces of globalization (Baldwin, 2019). Neglect of services in the design of trade and investment policies would imply a significant loss of growth and development opportunities.

**G20 Economies have a particularly high stake in services trade**

This policy brief is directed to policy-makers in the G20, a grouping that comprises the world’s leading services traders and accounts for roughly 80% of global services trade and investment. (WTO, 2018b). G20 economies are predominantly service economies. The sector employs 68% of the G20 workforce, and 79% of female employment. Services further contribute three fifths (59%) of aggregate G20 output. Even relatively small improvements in services trade policy can be expected to translate into sizeable economic gains for G20 countries and their citizens (IMF, 2018).

**Proposal**

G20 policy-makers need to make trade and investment in services a more central pillar of policy formulation, consonant with the dominant role played by services in modern economies. We recommend the following steps.

**Send a clear signal recognizing the importance of services trade for sustainable, balanced and inclusive growth.**

The inclusion of dedicated discussions on services trade within the G20 Trade and Investment Working Group agenda is needed to raise the prominence of the topic at a time of mounting trade policy turbulence.

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2 ILOSTAT, 2018  
3 World Bank, World Development Indicators, 2018
Services constitute a large and growing share of global trade

Services, including the vast array delivered online, represent the new frontier of global trade and investment governance. Their role in international trade and investment flows has been systematically underappreciated. New datasets measuring trade in value-added terms reveal that services represent close to half of world trade, a much larger share than previously thought (Miroudot and Cadestin, 2017). For G20 countries, this number increases to over 50% (WTO/OECD, 2018).

The rising share of services in total trade is also the result of major structural changes occurring in the very fabric of economic activity in the digital era, intertwining goods and services trade and investment more than ever. The so-called “servicification” of manufacturing captures the tendency of manufacturing firms to procure, both at home and abroad, more services inputs than before, and to sell and export more services as integrated or accompanying components of their merchandise exports (e.g. Kommerskollegium, 2012). More broadly, servicification reflects that value creation in all economic activity is shifting towards upstream segments as inputs “embodied” during the production process (e.g. R&D, design, and professional expertise) and to downstream activities “embedded” at the point of merchandise sale (e.g. financing, training, maintenance, repair and other after-sales services). Such shifts have prompted the emergence of new business models at the interface of goods and services production (Stephenson, 2017).

Services trade is key to productivity, inclusiveness and diversification

As G20 countries’ productivity growth remains sluggish, recognizing the role of servicification and services trade for performance and productivity for all firms should be a priority for policy-makers eager to achieve sustainable growth. Recent studies have found that the effects of increased services trade are not confined to the services sector, but have important positive knock-on effects on
other sectors of the economy (see eg. Arnold et al., 2015, Crozet & Milet, 2017, and Beverelli et al., 2017).

Realization of a range of sustainability and inclusiveness objectives depends crucially on bolstering the performance of services sectors and improving access to specific services, for which trade and investment can play a key role (Fiorini and Hoekman, 2018). Telecommunications, transport, financial, health, education and environmental services are examples of services that are essential to improving lives and opportunities, through connecting people and markets and improving human capital. The services sector is by far the largest driver of job creation in G20 countries, a trend on the increase with servicification (Schwarzer, 2015). As the predominant source of global female employment, services hold considerable potential for more inclusive growth patterns (Ngai and Petrongolo, 2017).

Finally, expanding the service economy and boosting trade and investment in the sector may be an important pillar of economic diversification strategies - notably for countries with high commodity dependence - and may contribute to the reduction of global imbalances. Recent discussions on current account surpluses and deficits revolve almost entirely around the goods trade balance. While goods traded do embed services, the predominant focus on merchandise trade flows and especially bilateral goods trade balances paints only a partial, distorted, picture. External balances in services often mitigate the trends observed in goods trade, and expanding services trade according to comparative advantage may contribute to reducing overall external balances in the medium-term (IMF, 2018). As such, the services sector can provide a cushion to economic downturns, as has been witnessed during the last recession, when countries with a larger proportion of their exports in services experienced a lesser reduction in trade than did those with a higher proportion of their exports in manufacturing / agriculture (eg Borchert and Mattoo, 2009, and Ariu, 2016).
“Audit” national services trade and investment policies and regulations as a foundation for concerted G20 action

Services are increasingly part of trade agreements...

Over the past ten years, 77% of all signed preferential trade agreements have included provisions on trade and investment in services, up from only 16% in the 1990s. There is an increasing tendency towards incorporating provisions on services in free trade agreements (see Figure 1).

Figure 1

Source: DESTA Project

At the same time, services negotiations meet with increasing public resistance. Points of criticism include allegedly insufficient carve-outs for public services such as health and education, as well as alleged pressures placed on governments to open sensitive areas, such as energy, transport and financial
services to heightened foreign competition. Controversy around privacy and market power in the context of the digital economy are further cases in point.

... but barriers remain pervasive and very high.

Compared to barriers impeding goods trade, obstacles to trade and investment in services remain pervasive. Such obstacles are also often more complex, harder to quantify and protectionist elements may at times be difficult to distinguish from regulation enacted in pursuit of legitimate public policy goals. The ongoing “Fourth Industrial Revolution”, epitomized by technological disruption and the rise of the digital economy, adds another layer of urgency to the need to address services-related issues internationally and to update the global rule-book governing trade and investment in the sector set out in the General Agreement on Trade in Services (GATS).\(^4\)

Even though the GATS contains an explicit mandate to negotiate further rules and commitments on services, the varied interests of an increasingly diverse WTO membership have proven to be a major obstacle to discussions that resumed in 2000 without yet producing tangible outcomes. Consequently, a large discrepancy exists between the level of services trade and investment commitments made under the GATS and the actual level of policy openness captured by the OECD Services Trade Restrictiveness Index (STRI) across countries (see Figure 2).\(^5\)


\(^5\) The OECD STRI is a composite index that ranges between 0 (completely open) to 1 (completely closed).
Figure 2

Source: OECD, 2017

The discrepancy between bound services trade and investment commitments and applied policy is a general feature of services trade both under the WTO GATS and in preferential trade agreements (PTAs). Figure 3 compares four different services trade restrictiveness benchmarks across former TPP countries - which include all CPTPP countries plus the US which has withdrawn from TPP. The TPP – and now the CPTPP – is widely hailed to be the most progressive trade agreement in terms of services policy.

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6 This graph relies on the World Bank STRI that ranges between 0 (completely open) and 100 (completely closed).
Strengthening the Rules-Based Trading System

Figure 3

Source: Gootiz and Mattoo (2017)

The first bar (in blue) depicts the latest multilateral benchmark represented by the offers of the now defunct Doha Round, which some countries have designated to be the minimum level of ambition for a possible future Trade in Services Agreement (TiSA). The brown and green bars represent aggregate policy levels for their most progressive PTA and the TPP deal respectively, whereas the orange bar denotes the actual level of applied services policy as of 2015. A tendency towards progressive alignment between international commitments and applied policy is certainly discernible, suggesting that the real current value of PTAs, including the CPTPP, is in enhancing transparency and certainty by reducing the gap with applied policy, irrespective of any significant overall improvements in terms of market access. This interpretation is corroborated by recent research on the benefits of reducing policy uncertainty for trade (Handley and Limão (2017). Lamprecht and Miroudot
(forthcoming) estimate that going from the level of commitments bound in GATS to the average level in PTAs is associated with a significant positive impact on trade in the range of 8% to 12% depending on the sector. For developing countries, the trade-enhancing effect of PTAs that cover services is almost double the effect of PTAs that only cover goods (Lee, 2018), confirming the importance of services trade for development.

Despite faring relatively well in comparison with international commitments, applied restrictions in most services sectors are nevertheless rampant (Figure 4). These restrictions translate into sizable trade cost equivalents that significantly exceed average tariffs on traded goods. According to OECD (2019), the resulting price increases can be expressed in terms of tax equivalents that can reach up to almost 80% in certain countries, inflicting substantial additional costs on firms using these services as well as in higher prices for final consumers. These trade costs fall disproportionally on small and medium sized enterprises (SMEs), which generally do not have the resources to deal with regulatory hurdles and divergences, resulting in an additional 7% in trade costs relative to large firms (OECD, 2019).

![Graph showing trade cost equivalents by sector](image)

*Figure 4: STRI average, minimum and maximum scores by sector, 2018*

Source: OECD (2019)

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7 The STRI covers all 36 OECD countries, Brazil, the People’s Republic of China, Colombia, Costa Rica, India, Indonesia, Malaysia, Russian Federation, and South Africa
Policies need to be reviewed in order to stimulate trade

Against this background, it is of crucial importance that policy-makers place services at the center of their future work, reviewing their existing policies in view of the trends depicted in this brief. Given the relatively high level of restrictiveness in services trade policy, a careful reconsideration of existing policy and alignment with best practices that allows to reduce trade costs while maintaining regulatory priorities should be viewed as a low-hanging fruit for policy-makers eager to improve domestic economic performance. Failure to do so would imply a significant loss of growth and development opportunities. Collective efforts among economies to take stock of their existing policies in services such as underway in APEC are to be commended.

The G20 should support concerted action

Unilateral policy steps to audit national services trade and investment policies and regulations should be viewed in light of preparing the ground for concerted action by G20 countries to streamline their international commitments to reflect these realities. Recent initiatives on both a global and regional basis to enhance transparency and efficiency in domestic regulation of services sectors and to cooperate in developing a framework for international governance of e-commerce and digital trade are important steps in the right direction and should inspire momentum across all aspects of services trade and investment policy.

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TRADE, INVESTMENT AND GLOBALIZATION

Expanding and Restructuring Global Value Chains for Sustainable and Inclusive Growth

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Abstract

Global value chains (GVCs), networks of firms through international trade of goods and services, investment, and research activities, had expanded in the world economy in the 1990s and early 2000s. GVCs generate benefits for both advanced and developing countries through efficiency gains, diversification, knowledge diffusion and job creation.

However, the expansion of GVCs has slowed down since the global financial crisis in 2007-2008 because of insufficient human capital and infrastructure, as well as regulatory and institutional barriers. In addition, the slowdown is triggered by GVCs' adverse effect on some manufacturing firms in advanced countries due to competitive pressure from emerging countries that results in the rise of protectionist sentiments and policies.

To achieve sustainable and inclusive growth, GVCs should be expanded and restructured by (1) developing human capital and infrastructure, (2) promoting business matching, (3) removing regulatory and institutional barriers, (4) upgrading manufacturing sectors in advanced countries, and (5) reducing excessive protectionist sentiments.
**Challenge**

**Benefits of global value chains (GVCs)**

In the world economy, a large number of firms are connected beyond national borders through global value chains (GVCs). GVCs consist of various types of inter-firm relationships, such as supply chains and the off-shoring of business activities of both manufacturing and services, shareholding relationships, and research collaboration. The expansion of GVCs provides benefits to both advanced, emerging and developing countries in various ways.

First, because of GVCs, a country does not need to maintain a full set of industries domestically. Rather, a country can achieve economic growth by specializing in the production of particular goods or services and providing them to GVCs. Accordingly, GVCs enable firms, particularly those in emerging and developing countries, to create jobs and increase outputs and wages.

Second, firms locate production plants and service centers that mostly require low skills in developing countries that feature lower wages while locating managerial headquarters and research and development (R&D) centers that require higher skills in more advanced countries. This approach results in efficient allocation of resources, leading to welfare gains in both types of countries.

Third, GVCs contribute to the world economy by facilitating international knowledge diffusion. Knowledge spillovers from foreign direct investment (FDI) to domestic firms and learning by exporting have been observed in both advanced and developing countries. International research collaboration, which is often associated with trade and investment relationships and has become an important part of GVCs (Figure 1), has accelerated technological

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1 Baldwin (2016).
2 See Blomström and Sjöholm (1999), Haskel, Pereira, and Slaughter (2007), and Keller and Yeaple (2009) for FDI spillovers in Indonesia, the United Kingdom, and the United States, among many others. Additionally, see Blalock and Gertler (2008) and Javorcik (2004) regarding spillovers through input-output linkages and Todo (2006), Todo and Miyamoto (2006), and Todo, Zhang, and Zhou (2011) regarding spillovers from FDI in R&D.
progress in the era of open innovation. International knowledge diffusion through GVCs is critical to the welfare of the world economy, because it enables advanced countries to achieve sustainable growth and developing countries to catch up with advanced countries.

Finally, expanded GVCs enable firms to diversify their partners geographically and thus to mitigate propagation of negative effects from partners in particular countries because of political conflicts and natural disasters. Such geographic diversification of business partners through GVCs has become an important channel of risk mitigation, as natural disasters hit the world economy more often recently than before due to climate change and seismic cycles.

**Barriers to the expansion of GVCs**

Despite their benefits, the expansion of GVCs has slowed down since the global financial crisis in 2007 and 2008, as there are two major challenges to GVCs. First, the majority of firms, particularly most small and medium-sized enterprises (SMEs) in developing countries and many SMEs in underdeveloped regions in advanced countries, are not internationalized, i.e., they are unconnected to GVCs. Research collaboration among firms is often conducted within the country, not across countries, although international collaboration is increasing (Figure 1).

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3 Chesbrough (2003) develops the concept of open innovation. Iino et al. (2018) find that the quality of patents is 36% and 23% higher when the firm engages in international collaboration than when it engages in no collaboration and domestic collaboration, respectively.

4 See Barrot and Sauvagnat (2016) for the presence of intra-national propagation of negative shocks due to natural disasters and Kashiwagi, Todo, and Matous (2018) for how internationalization of firms can mitigate such propagation.

Figure 1: Research Collaboration Networks among Firms (2006-2010)

Source: Iino et al. (2018). Data are taken from Orbis.

Notes: Each dot represents a firm in the world. Firms connected through research collaboration are located closer to each other. Different colors are used for firms located in each of the top six countries in terms of the number of patents granted. Therefore, clusters of firms in the same color indicate dense research collaboration within the country, whereas clusters in different colors represent active international research collaboration.

There are several reasons for the limited expansion of GVCs. First, it is well known that the most important determinant of firms' internationalization, e.g., exports and FDI, is productivity.\(^6\) Firms' low human capital and resulting low productivity do not allow them to compensate for the initial costs of participating in GVCs, e.g., costs of searching for business partners and learning about foreign markets. Therefore, only a limited number of firms are connected to GVCs.\(^7\)

Second, the initial costs are particularly high in underdeveloped countries and regions because of poor infrastructure for transportation and information and communication technology (ICT). This poor infrastructure prevents flows of the products and information needed to participate in GVCs.

Third, many countries feature regulatory and institutional barriers that result in large costs of international transactions. Such barriers include restrictions


on foreign investment, local content requirements, inefficient customs procedures, poor intellectual property rights protection, and visa regulations.\(^8\) The number of new discriminatory interventions against foreign commercial interests by G20 countries has been increasing, as documented by a policy brief at the T20 last year.\(^9\)

**Rise of protectionism**

In addition, policy makers in many countries hesitate to expand GVCs in their countries because some individuals and sectors may lose as a result of GVCs. For example, imports from China to the United States (US) are reported to deteriorate income and employment in the US manufacturing sector.\(^10\) Other evidence shows that globalization is associated with rising income inequality among citizens in developed countries.\(^11\)

Rising inequality has resulted in protectionist sentiments and policies in a number of countries. Most notably, the US withdrew from the Trans-Pacific Partnership Agreement (TPP) and pressured to re-negotiate NAFTA, the United Kingdom (UK) decided to exit (Brexit) the European Union, and the US and China are involved in trade conflicts by reciprocally raising tariffs. These protectionist policies are supported by citizens’ protectionist sentiment: Only 30-40% of citizens in the US and Europe and 20% of those in Japan believe that international trade creates jobs (Figure 2). This rising skepticism about globalization and resulting protectionist policies prevent GVCs from expanding further.

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\(^8\) We do not argue more explicit trade restrictions, such as tariffs, in this policy brief, because this issue is extensively argued in other policy briefs.


\(^10\) Acemoglu, Akcigit, and Kerr (2016) and Acemoglu et al. (2016).

\(^11\) See, for example, Jaumotte, Lall, and Papageorgiou (2013), Milanovic (2013), and Piketty (2017). Another possible cause of income inequality is skill-biased technological change (Card and DiNardo 2002).
Figure 2: Attitudes toward International Trade

Source: Pew Research Center (2018)
Note: Europe consists of France, Germany, Greece, Italy, Poland, Spain, and the United Kingdom.

Proposal

1. Development of human capital and infrastructure
Because a major barrier to the expansion of GVCs is the low productivity of firms, human capital investment through formal education and business training certainly helps firms in countries of all income levels to participate in GVCs. In more advanced countries, graduate-level education should be provided to a wider range of populations, including current workers. In less developed countries, vocational-level education is more important to participate in GVCs, while tertiary-level education should not be ignored to attract FDI in R&D and promote domestic innovation for emerging countries. Also, GVCs have not penetrated some regions of the world, partly because of a lack of transport and ICT infrastructure. The positive effect of transport and ICT infrastructure on trade, knowledge diffusion, and economic growth is well
supported by empirical evidence. The importance of ICT infrastructure should not be underestimated because the offshoring of services, such as software development and call center operations, through the Internet has become a significant component of GVCs. Therefore, G20 countries should build up more transport and ICT infrastructure so that a wide range of firms can participate in GVCs.

In addition to the government of each G20 country, the roles of international organizations, such as the World Bank and regional development banks, provide a strong base for funding infrastructure. Also, G20 members are suggested to establish a G20 Fund for infrastructural investments.

2. Promotion of business matching and information dissemination
Firms may be reluctant to participate in GVCs because bearing costs of searching business partners and learning about foreign markets by individual firms is inefficient because of information spillovers. Therefore, governments should intervene and encourage business matching among firms by, for example, organizing and subsidizing trade fairs and matching sites on the Internet. In addition, governments should support the dissemination of information in foreign markets. Matching for international research collaboration through, for example, science and technology fairs and industry-university linkages should also be encouraged for further innovation. These policy measures should particularly target small and medium-sized enterprises (SMEs) as they sufficient suze to cover the initial cost of participating in GVCs.

3. Removal of regulatory and institutional barriers
Regulatory and institutional barriers should be lowered to reduce costs of international transactions. Particularly,

- Restrictions on foreign investment and local content requirements should be minimized, although restrictions in specific cases such as national security and intellectual property rights may be allowed.

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14 Such export promotion programs have been often found effective (Van Biesebroeck, Konings, and Volpe Martincus 2016).
● Customs procedures in developing countries should be more efficient by, for example, reducing red tape and introducing electronic customs.\(^{15}\)
● Product standards should be harmonized with global standards so that firms do not need to modify their products when they export to foreign markets.
● Intellectual property rights protection should be strengthened so that foreign firms are encouraged to engage in knowledge activities.
● Visa regulations should be relaxed to allow more efficient international labor allocation and knowledge diffusion.

These approaches to lower regulatory and institutional barriers are often incorporated in recent free trade agreements (FTAs), such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP11). Such extended FTAs should be encouraged and, if possible, multilateralized by means of new rules in the context of the WTO.

4. Upgrade of manufacturing sectors in advanced countries

Because some workers in advanced countries suffer from competitive pressure from emerging countries, simply expanding GVCs may induce more protectionist policies and thus instability in the world economy. Therefore, GVCs should be restructured so that a wider range of citizens can benefit from GVCs.

For this purpose, upgrading manufacturing sectors in advanced countries is necessary. If advanced countries produce the same products as emerging countries do, they will never win the competition for lower prices. Therefore, advanced countries should produce goods and services of higher value added. Then, connecting to GVCs does not necessarily incur losses for advanced countries.\(^{16}\)

For such restructuring, human capital investment at very high levels in advanced countries is needed. High human capital enables manufacturing firms

\(^{15}\) Reducing time for exporting procedures drastically is shown to increase welfare gains from FTAs (Itakura 2014).

\(^{16}\) There are studies showing that GVCs can benefit manufacturing sectors in advanced countries, depending on the industry and trade structure. See, for example, Fabinger, Shibuya, and Taniguchi (2017).
to produce high value-added goods and services and further engage in R&D, product design, and global management and marketing. This transformation requires both the re-education of current workers and the education of current students.

Furthermore, restructuring GVCs requires the destruction of outdated industries and the creation of state-of-the-art industries in advanced countries. To change the industry structure smoothly, the mobility of workers across industries and countries should be enhanced. Therefore, regulations that prevent labor market mobility should be eliminated. It should be emphasized that this restructuring of GVCs does not hurt emerging or developing countries but instead creates more jobs in these countries through the re-allocation of industries across countries. Particularly, if combined with other policy measures suggested earlier, this restructuring of GVCs should enable emerging and developing countries to speed up their economic growth through knowledge diffusion.

5. Reduction of excessive protectionist sentiment through interventions
Rising income inequality in advanced countries is surely a source of protectionism in these countries. However, there may be another reason. As Figure 2 shows, two-thirds of citizens in advanced countries are skeptical about the benefits of globalization, although empirically it is evidenced that globalization improves aggregate income in the world economy. This suggests that the current protectionist sentiment is excessive, compared with what we would expect from the current level of income inequality.

Therefore, citizens' lack of knowledge about the benefits of globalization may be another cause of protectionist sentiment in advanced countries. The Pew Research Center survey (2018) mentioned above also indicates that more educated citizens in developed countries are more likely to believe that trade creates jobs, which may be because more educated citizens are less likely to be adversely affected by globalization – but it may also be because they have more opportunities to learn about the benefits of globalization. Therefore, educating a wider range of citizens, including children and currently less educated workers, about the benefits of globalization is of great importance to reduce protectionism.
Finally, another possible measure to address the rise of protectionism should take a behavioral-economics approach because people are not necessarily rational in terms of monetary benefits and protectionism may be based on the intrinsically closed nature of human beings. Empirical studies show that social interactions promote trust in others and support for free trade, while strong within-group ties and social conflicts beyond the group generate persistent distrust and hostility to outsiders. Therefore, international exchange programs, such as exchanges of students, business and academic conferences, as well as research collaboration, should be encouraged and subsidized by governments to promote mutual understanding and trust in the world. In particular, providing children opportunities to understand foreigners and to become open-minded could substantially reduce protectionism and increase benefits from globalization in the long run.

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Strengthening the Rules-Based Trading System

Towards G20 Guiding Principles on Investment Facilitation for Sustainable Development*

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Abstract

There is growing support behind an international framework to facilitate investment for sustainable development. This Policy Brief suggests that the G20 consider adopting Guiding Principles on Investment Facilitation for Sustainable Development, to help ensure that these efforts result in an effective, coherent, and development-oriented outcome. To this end, this Brief proposes guiding principles to: (1) orient investment facilitation, (2) facilitate sustainable FDI, (3) integrate facilitation throughout the investment lifecycle, (4) engage in multistakeholder consultations, (5) ensure shared responsibilities, (6) encourage cooperative activities, (7) adopt a whole-of-government approach, (8) focus on national efforts within a multilateral framework, and (9) support capacity building coupled with flexibility.

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Challenge

The world faces the challenge of raising an additional US$2.5 trillion annually to reach the Sustainable Development Goals.\(^1\) At the same time, there are currently over US$100 trillion in assets under management, expected to rise to over US$145 trillion by 2025.\(^2\) There is therefore not a dearth of capital, but rather a dearth of capital flowing to profitable projects that contribute to sustainable development. At the same time, global FDI flows have actually declined by more than one third over the past three years, falling from US$1.9 trillion in 2015 to US$1.2 trillion in 2018, a low point last seen in 2009 after the global financial crisis.\(^3\) This decline is all the more deplorable, as FDI—like trade—is a win-win proposition, especially considering that such investment not only involves capital flows but can also involve other resources central to development, such as technology transfer, the upgrading of human resources, access to markets, and growing exports. Moreover, considering that the bulk of FDI is in the services sector and hence is tightly intertwined with trade in

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services, the performance of FDI flows has direct implications for the role of services trade in achieving G20 objectives.\(^4\)

This leads to two closely intertwined goals:

(1) How to increase the *flow* of foreign direct investment; and

(2) How to increase the *benefits* from foreign direct investment.

**Investment facilitation provides an innovative approach to help achieve both goals.**

Investment facilitation is broadly conceived as an international framework of non-controversial, technical measures that can increase the *quantity* and *quality* of investment. Since virtually all economies both receive and export investment capital,\(^5\) investment facilitation has the potential to benefit all economies. Yet, given that developing and least-developed countries often lack the capacity to attract foreign direct investment (FDI) – and that FDI is often their largest source of finance \(^6\) – investment facilitation is particularly important for these countries. As investment facilitation mainly targets foreign

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direct investment, this brief focuses on FDI. It is worth noting, however, that improvements in domestic regulatory systems through facilitation efforts are likely to also generate significant benefits for domestic investors.

**Why should the G20 take up this issue?**

- Discussions on investment facilitation have been very dynamic – from the national to the multilateral levels – generating a need for high-level guidance to achieve effective, coherent, and development-oriented outcomes.\(^7\)

- The need for such guidance was already recognized and called-for by the T20 in 2018.\(^8\)

- G20 economies represent 88 percent of global outward FDI stock and thus have both an interest in supporting an international framework to facilitate investment and the legitimacy to do so.\(^9\)

- The G20 adopted Guiding Principles for Global Investment Policymaking in 2016 and launched the Compact with Africa in 2017, both of which

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emphasize the importance of investment facilitation as a key dimension of investment policy.\textsuperscript{10}

- The Trade Facilitation Agreement came into force in 2017, but given that trade and investment are increasingly interlinked, trade facilitation will be much more effective if undertaken together with investment facilitation—and vice versa.\textsuperscript{11} In fact, some FDI—like investment in telecommunications, ports, airports, roads, and railways—can be thought of as trade facilitation.

The G20 Guiding Principles for Global Investment Policymaking have served as an important signal for international investment policy reform. The G20 can draw from this experience and adopt non-binding Guiding Principles on Investment Facilitation for Sustainable Development, thus providing orientation, contour, and impetus to discussions in this emerging area.


Proposal

The G20 should adopt non-binding Guiding Principles on Investment Facilitation for Sustainable Development

With the objective of (i) leveraging investment for inclusive economic growth and sustainable development, (ii) ensuring that investment policy and measures are transparent, efficient, and effective while preserving policy space and regulatory sovereignty, and (iii) supporting efforts at the national level to attract and leverage investment for sustainable development while creating an international framework that provides benchmarks, good practices, and orients international assistance, the G20 may wish to consider the following non-binding principles to provide guidance to efforts in support of investment facilitation.

1. Orient investment facilitation

Investment facilitation should be concerned with practical aspects and technical measures to support the flow of investment. In so doing, investment facilitation should focus on areas where there is generalized interest and support – from firms and governments – such as improving transparency and predictability of investment measures, streamlining procedures, and enhancing coordination and cooperation between actors. Facilitation efforts should not include the controversial and polarizing areas of market access, investment protection, and investor-state dispute settlement. In particular, investment facilitation should not be conceived in such a way that it restricts the policy space of national governments and should leave considerable flexibility with implementation. Where relevant, investment facilitation efforts can draw from the earlier experience of trade facilitation efforts, both in terms of process and substance, that led to the successful adoption of the Trade Facilitation
Agreement. Investment facilitation efforts can also draw from the analytical work undertaken by international organizations.12

Guiding Principle 1: Investment facilitation should focus on practical aspects and technical measures to support the flow of investment – and not deal with market access, investment protection, and investor-state dispute settlement – thereby maintaining the policy space of national governments. To this end, investment facilitation should draw from both the lessons of the Trade Facilitation Agreement and the experience of international organizations.

2. Facilitate sustainable FDI

When governments facilitate investment, they do not seek foreign investment for its own sake, but for its development benefits. As a result, economies aim not only to increase the quantity of FDI but also its quality, as measured by its contribution to sustainable development. In other words: sustainable FDI for sustainable development. 13 Any international framework on investment facilitation should therefore promote not only FDI in general, but especially sustainable FDI, i.e., FDI that is at once commercially viable and makes a maximum contribution to economic, social, and environmental development.14 Facilitation efforts should also support FDI that takes place on the basis of proper governance mechanisms (such as environmental impact studies, stakeholder consultations, and risk-management mechanisms). In this context, the promotion of linkages between foreign affiliates and domestic firms is

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particularly important. To facilitate sustainable FDI, governments, firms, and other key actors can use an indicative list of FDI ‘sustainability characteristics’.\textsuperscript{15}

Guiding Principle 2: Investment facilitation should be focused on ‘sustainable FDI for sustainable development’, by especially facilitating FDI that is both commercially viable and makes a maximum contribution to the sustainable development of host and home economies.

3. Integrate facilitation throughout the investment lifecycle

A focus on sustainable FDI can shape facilitation efforts across an FDI lifecycle comprised of five stages: (1) development of an FDI vision or strategy, (2) FDI attraction, (3) FDI entry and establishment, (4) retention of FDI, including dispute prevention, and (5) and fostering linkages between foreign and domestic firms to increase the benefits of FDI.\textsuperscript{16} Crucially, investment facilitation can play a role – and should be integrated – in each stage of this lifecycle. Until now, discussions about investment facilitation have principally focused on stage (3), the host economy’s policies and procedures regarding the entry and establishment of foreign investment, and have paid less attention to the importance of facilitation at the post-establishment stage and beyond. Of particular importance is the role of facilitation to prevent investment disputes, not only because these disputes can be costly in and of themselves, but also because they can discourage both reinvestment and new investment.\textsuperscript{17}


Economies can put in place mechanisms to identify and address investment irritants and complaints before they become formal disputes, and in so doing avoid the concomitant economic, reputational, and political costs.\textsuperscript{18}

\textit{Guiding Principle 3: Investment facilitation should integrate facilitation efforts across each stage of the investment lifecycle.}

\textbf{4. Engage in multistakeholder consultations}

The input and guidance of stakeholders is essential to understand facilitation needs across the lifecycle, and for facilitation efforts to achieve real impact. The reason is that stakeholders – including investors and representatives of investment promotion agencies, but also other stakeholders from academia and civil society – can help identify the operational, ground-level constraints to investment that facilitation efforts can address. This should help ensure that measures included in any international framework will be designed in a manner that addresses the actual challenges to increasing both the quantity and quality of FDI, through what has been called a “collective process of discovery”\textsuperscript{19}. As a result, while investors, business associations, and investment promotion agencies will likely be the most important constituents of this consultative process, other stakeholders should also be included to ensure input from all relevant parties.


Guiding Principle 4: Investment facilitation should benefit from a multi-stakeholder process of consultations and cooperation in formulating and implementing measures, especially input from investors, business associations, and representatives of investment promotion agencies.

5. Ensure shared responsibilities

At the same time as stakeholders help shape facilitation efforts, they also have a shared responsibility for its implementation. At present, international investment agreements provide for host country governments to play the leading role in managing FDI – including its attraction, retention, and impact on the domestic economy – with little active role of home country governments or firms. However, both home country governments and firms are increasingly adopting measures to shape outward FDI decisions and behaviors.20 On the one hand, home country governments have adopted national guidelines for how their firms carry out outward FDI,21 and embraced multilateral efforts such as the OECD’s Guidelines for Multinational Enterprises.22 On the other hand, firms have adopted their own codes of corporate social responsibility, and also embraced multilateral efforts such as the Principles of Responsible Investment.23 Home country governments and firms are therefore poised to play an increasingly active role in facilitating sustainable FDI. A balanced


approach with shared responsibilities among these and other stakeholders is more likely to lead to sustainable development outcomes by boosting trust, increasing collaboration, and ensuring that investments have broad buy-in and support.

Guiding Principle 5: Investment facilitation should strive for shared responsibilities among stakeholders, especially host country governments, home country governments, and investors.

6. Encourage cooperative activities

One of the clearest ways to foster shared responsibility and drive successful facilitation is through cooperative activities, especially between host and home economies. This is the case for at least three reasons. First, cooperative activities lead to a better understanding of the respective facilitation needs and priorities in each economy, allowing targeted measures to directly and efficiently address these needs and priorities. Second, cooperative activities create partnership and mutual learning, building a foundation of trust for all other investment facilitation measures that may be considered. Third, cooperative activities help obviate the impression that one economy may be benefiting more from investment facilitation than the other, as cooperative activities should be guided by mutual interest and designed for mutual benefit. A cooperative approach is therefore likely to be most effective in providing information, identifying bottlenecks, streamlining regulations, coordinating measures, facilitating two-way investment, and overall generating win-win investment outcomes between economies. Cooperative activities are already starting to take place, for instance through outward investment agencies and investment promotion agencies (from different economies) organizing joint business missions and promotion activities to support win-win, two-way investment.
Guiding Principle 6: Investment facilitation should encourage cooperative activities between home and host economies, especially their respective agencies promoting inward and outward investment. Cooperative activities can also, where useful, be undertaken with other stakeholders and be regional in nature.

7. Adopt a whole-of-government approach

Cooperative activities with foreign governments can only be effective if there is coordination and alignment within the national government. Yet, there are challenges to coordinating across governmental agencies and across government levels. Often challenges arise for foreign investors from the regulatory actions of single domestic agencies that are not aware of the country’s investment policy or international commitments. At other times, the actions of municipal and provincial regulatory authorities may not be aligned with investment policy set at the national level. A whole-of-government approach can help overcome these unintended ‘horizontal’ and ‘vertical’ regulatory impediments to investment, which undermine a country’s ability to leverage investment for development. A whole-of-government approach ensures that agencies cooperate across portfolios to achieve consistency and coordination regarding investment policy. This approach brings together different government stakeholders to better align efforts, increase effectiveness, cut costs, boost competitiveness, and generate synergies.

Guiding Principle 7: Investment facilitation should be based on a whole-of-government approach, ensuring participation by, and cooperation among, all levels of government and all institutions dealing with investment.

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8. Focus on national efforts within a multilateral framework

The need for a whole-of-government approach just described is underpinned by the fact that investment facilitation first and foremost takes place at the national level through the work of government institutions. These institutions formulate and implement investment regulations, a primary locus of facilitation efforts. At the same time, bilateral and multilateral approaches can support and build on national activities in what could be called a ‘tiered’ system. A multilateral approach, in particular, is more likely to produce an inclusive framework that reflects the interests and needs of economies at all stages of development, and thus is more legitimate, stable, and impactful. In addition, there are two reasons why it is in the interests of economies to extend an investment facilitation framework on a most-favored-nation (MFN) basis even to those economies that may not participate. First, an MFN basis will increase the likelihood of participating economies receiving inward investment, since it will facilitate inward investment from all economies, irrespective of their participation (non-participating economies, in contrast, will not benefit from an increase in inward investment flows generated by facilitation efforts). Second, given the growing integration of trade and investment, participating economies are more likely to gain from trade with partner economies if they facilitate investment from them as well, irrespective of the trading partners’ participation in the investment facilitation framework. This same logic may have helped determine that the Trade Facilitation Agreement be applied on an MFN basis, creating even more of an incentive to apply investment facilitation on an MFN basis if the gains from trade and investment are to be fully realized.

Guiding Principle 8: Investment facilitation should first and foremost focus on national efforts, but also be multilateral in nature, designed by and for all economies through an inclusive process, and with the ensuing results applied on a most-favoured-nation basis.
9. Support capacity building coupled with flexibility

The preceding eight principles will be ineffective without sufficient capacity building and flexibility. The reason is that economies are not at the same level in terms of identifying, negotiating, adopting, and implementing facilitation measures. For an investment facilitation framework to succeed, there must thus be support for capacity building throughout the process, crowding-in the participation of economies at different levels of development. Key to success will be a combination of flexibility and support, as gleaned from the successful Trade Facilitation Agreement. Developing countries and LDCs could (1) decide how long they require to implement commitments, (2) make commitments contingent on technical assistance, and (3) benefit from time windows to change commitments or grace periods. The Trade Facilitation Agreement, furthermore, provides for the establishment of (4) an Expert Group, as needed, to advise on implementation or management of commitments, as well as (5) a facility to provide technical assistance when not provided by donors and international organizations. This recipe of capacity building and flexibility has worked well for trade facilitation and can be replicated for investment facilitation, while adapting it as needed. This would allow all economies both to participate in discussions and have the needed flexibility to join a framework.

*Guiding Principle 9: Investment facilitation should include capacity building – throughout the process of developing and implementing facilitation measures – to ensure that economies at different levels of development can participate on an equal footing and that all can benefit from these efforts. Investment facilitation should also allow for flexibility in the implementation of commitments for countries across different levels of development to join.*

**Way forward**

The G20 may wish to add investment facilitation to the agenda of the Trade and Investment Working Group (TIWG) and suggest that the Ministerial Meeting on
Trade and Digital Economy on 8 June 2019 make a commitment to working on this issue. This would allow the TIWG to examine how investment facilitation can increase the level and benefits of investment flows, building on the Guidelines on Global Investment Policymaking and the Compact with Africa. The TIWG may also wish to request international organizations – especially UNCTAD, World Bank Group, WTO, and the OECD – to provide technical support to investment facilitation efforts. The TIWG could also consider the draft Guiding Principles on Investment Facilitation for Sustainable Development included in this Policy Brief. If adopted, the G20 could then request international organizations to assist with their implementation.

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