Crimes and Punishments?

An analysis of retaliation under the WTO

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Chapter 1: Introduction.

The World Trade Organization (WTO) is under fire and, surprisingly, the latest attack is not coming from anti-globalization protesters. Instead, the onslaught stems from an improbable source—the world’s two most important trading economies that have the largest stakes in the system: the United States and the European Union. As a result of a series of cases brought before the WTO Dispute Settlement Body (DSB), these economies could be on an upward spiral of retaliation and counter-retaliation. Such actions could do damage in several respects. They could undo the liberalization of previous trade negotiations, poison the atmosphere for future agreements, raise serious questions about the efficacy and legitimacy of the dispute resolution system, and strengthen the hand of those who oppose the WTO as an unwarranted intrusion on national sovereignty.

In April 1999, following rulings that the EU had failed to bring its illegal banana import system into compliance with WTO rules, the WTO authorized the United States to raise tariffs on $191.4 million dollars worth of European exports. Later that year, the US targeted an additional $116 million worth of European products because the EU had failed to comply with an adverse judgment in the dispute over hormone-fed beef. Dissatisfied with delays in settling the bananas case, the US Congress passed a “carousel” system that rotates the sectors targeted for retaliation although it was not invoked.3

After a prolonged struggle, the banana dispute was resolved, but in the interim the EU had successfully challenged American tax rules that allow exporters to establish an offshore Foreign Sales Corporation (FSC). In this case, it was the United States turn to make superficial changes in its tax system to comply with the adverse ruling by passing the Extraterritorial Income Exclusion Act (ETI). The EU successfully challenged ETI. It sought, and in August 2002 received, WTO permission to increase tariffs to obliterate $4.043 billion worth of US exports. The EU has also successfully challenged US steel safeguards. The EU at first threatened that it would retaliate with tariffs on an additional $2.2 billion worth of trade – and that some of these would be imposed without waiting for WTO approval on the grounds that prior approval was unnecessary.4 It later reduced its request to $350 million.

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2 When the WTO gives a member the right to respond to a violation it is common to hear the action described as a trade sanction, with the implication that the action is punitive. For clarity, let me make this implication explicit and reserve the term “sanction” as a synonym for a punitive measure, i.e. a measure or response that inflicts more damage than the measure precipitating the response. A second term, also commonly used to describe this action is “retaliation”, although retaliation is sometimes also taken to imply a punitive action, I will use the term as a synonym for a “response” that could be, but is not necessarily punitive. In this context, a punitive action would be one in which the value of trade eliminated by the retaliation is greater than the value of trade affected by the infraction.

3 Congress passed the “carousel” provision requiring periodic revision of retaliatory tariff lists as part of the Africa-Caribbean trade bill that President Clinton signed into law in May 2000.

4 The EU originally selected products worth 2.516 billion euros for steel retaliation. It planned to impose tariffs of between 15 and 30 percent to mirror the export values subject to the US steel tariffs. (Inside US Trade Website).
Were the EU actually to impose 100 percent tariffs on $4 billion worth of trade because of FSC, it would raise the average import-weighted tariff on US exports to the EU by about 1.8 percentage points. Although a small percentage of overall transatlantic trade, judged in terms of liberalization achieved in trade negotiations, this is a significant increase. For example, according to the World Bank, as a result of eight years of intensive negotiations in the Uruguay Round, the European Union countries reduced their import-weighted average tariffs by an estimated 1.6 percentage points. It is not an exaggeration, therefore, to say that these measures could more than eliminate the boost to US exports to Europe provided by tariff reductions in the Uruguay Round. Moreover, the social cost of the tariff increases would be much larger than the benefits of the reductions in the round because comparing averages ignores tariff peaks that are more damaging.

FSC retaliation would entail very high tariffs on a few products and microeconomic theory suggests that, under reasonable assumptions about the behavior of demand and supply, the social costs of a tariff rises with the square of the rate. (Thus a tariff of two percent inflicts four times the damage of a one percent tariff, and a tariff of three percent, nine times the damage of a one percent.)

And this is not the end of the story. In mid 2003, the US brought a case against the EU on its ban of American grains exports containing Genetically Modified Organisms. In addition, the Uruguay Round agreement on agricultural trade included a “Peace-clause” agreement not to use the subsidies code to challenge subsidies in agriculture until the end of 2003, but when this clause expires, the US could challenge EU agricultural export subsidies (worth $6 billion in 2000) and ratchet the feud upward yet another notch.

There is a danger that a cumulative arms-race dynamic could be at work. The timing of the FSC case, in particular, suggested this. Once the US recorded wins in Bananas and Beef that inflicted political pain, the European Commission felt compelled to retaliate with the FSC case. This was despite the fact that, with the exception of Airbus, there was not a very strong European constituency in favor of the case; indeed many EU multinationals benefit from the tax break. Moreover by bringing the case, the EU was breaking an implicit understanding that had stood for almost two decades.

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5 In 2000, according to the Bureau of Economic Analysis, the US exported $156.1 billion to the EU (measured on a balance of payments basis.)
7 See for example (Kenen, Peter B. 1994) page 23
8 For a discussion placing the bilateral WTO disputes in a broader context see (Bergsten, C. Fred 2001)
9 According to the WTO, “Article 13 ("due restraint") of the Agriculture Agreement protects countries using subsidies which comply with the (Agricultural) agreement from being challenged under other WTO agreements. Without this “peace clause”, countries could have greater freedom to take action against subsidies, under the Subsidies and Countervailing Measures Agreement and related provisions. The peace clause is due to expire at the end of 2003.” Source: http://www.wto.org/english/tratop_e/agric_e/negs_bkgmd13_peace_e.htm
10 According to Hufbauer and Newman, “The FSC legislation passed in 1984 -- providing a partial exemption for a foreign export sales subsidiary rather than deferral for a domestic export sales subsidiary -- went unchallenged throughout the Uruguay Round. In the mid-1990s, the European Union threatened to bring a FSC case before the WTO to stave off a looming US challenge over government subsidies for Airbus. That episode passed, but in 1997 the European Union did launch a FSC case largely
The atmosphere has also become more toxic because WTO panels have increased the prospects for large authorizations to retaliate in cases involving export subsidies, such as FSC. Arbitration panels have taken the view that these authorizations need not be confined to the impacts of such subsidies on plaintiff exports. The $4 billion the EU was authorized in the FSC case was equal to the full cost of the subsidies incurred by the US treasury. (Canada and Brazil have also been involved in a tit for tat struggle over aircraft subsidies, and have been authorized to retaliate against one another, although thus far neither has done so. Canada’s award was also equal to the full cost of the Brazilian subsidy while the arbitrators added an additional twenty percent to the subsidy cost in their authorization to Brazil.)

**Flawed system?** The spectacle of the world’s most important trading economies going at one another tooth and nail highlights what some believe to be serious flaws in the WTO’s system for responding to violations. Four of these concerns will serve as the focus of this analysis. They are that the system (a) may lead to more protection rather than more liberalization. (b) has failed to induce Members to comply with its rules; (c) undermines national sovereignty with an unstoppable dispute settlement process that encourages excessive judicial activism and can lead to trade sanctions; and (d), is inherently unfair. Consider each of these concerns.

*Increased protection.* The WTO is an organization designed to promote freer trade. Given this objective, the use of a system that allows retaliation through raising trade barriers is inherently risky. If retaliation induces compliance, it can help achieve the organization’s goals. But the system could be counterproductive if it is more powerful in encouraging retaliation that it is in deterring violations. An upward spiral of retaliations with strong punitive elements could set off a trade war. The prospect that the EU will agree to accept US hormone-fed beef currently appears dim: this ban and now, the US retaliation, have been in place for a lengthy period. The danger of increased protection because of such measures has led some critics to advocate discontinuing the practice of permitting retaliation through raising trade barriers. Instead, they recommend requiring violators to provide offsetting compensation by lowering other trade barriers, rather than retaliation by plaintiffs, and/or paying fines.

*Noncompliance.* This series of rulings against the United States and the European Union and the authorization of retaliation highlight their failure to comply with the rules. Aside from the damage it does to their credibility when preaching the virtues of free trade to other nations, the behavior of these two large participants calls into question

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11 Indeed the US still has 25 percent tariffs on truck imports that date from the “chicken wars” in the 1960s!

12 According to the Meltzer Commission "If countries do not accept WTO decisions, injured parties have the right to retaliate by putting restrictions on imports from the offending country or region. The injured country then suffers twice---once from the restrictions on its exports, imposed by foreign governments, and again when tariffs or duties raise the domestic cost of the foreign goods selected for retaliation…. The Commission proposes that, instead of retaliation, countries guilty of illegal trade practices should pay an annual fine equal to the value of the damages assessed by the panel or provide equivalent trade liberalization.”(IFIAC), International Financial Advisory Commission 2001)

13 Joost Pauwelyn likewise complains that WTO remedies are inadequate to enforce compliance. See (Pauwelyn, Joost 2000) See also (Brimeyer, Benjamin L. 2001)
the WTO’s ability to enforce a trading system based on rules. If the largest players do not stick to the rules, surely others will feel freer to do likewise. According to Petros Mavroidis, for example, the persistent violations of the agreement suggest that the penalties for non-compliance are inadequate. Accordingly, he and others advocate tougher penalties for noncompliance and strengthening the nature of the legal obligations.

Another concern relates to the delays involved in reaching decisions, determining non-compliance and authorizing retaliation. Since complainants who win their cases are not entitled to retroactive compensation, offending members get away with violations for an extended period of time and have an incentive to make the dispute process more protracted. As a result, some have advocated measures for speedier responses and perhaps even permitting retroactive suspension of benefits to remove the incentives for delay.

_Undermining Sovereignty._ Yet tougher penalties would surely enrage critics on both the right and the left such as those who urged the United States to reject the Uruguay Round agreement on the grounds that the Dispute Settlement Understanding (DSU) already undermines national sovereignty. Indeed, the policy issues on which Ralph Nader and Patrick Buchanan have similar views are few and far between, but both agreed that by participating in the World Trade Organization, the United States seriously undermined its sovereignty.  

According to Ralph Nader,

“Few people have considered what adoption of the Uruguay Round agreement would mean to U.S. democracy, sovereignty and legislative prerogatives…decisions arising [from the World Trade Organization] governance can pull down our higher living standards in key areas or impose fines and other sanctions until such degradation is accepted.”

Similarly, Patrick Buchanan recalls with approval that,

“on October 18, 1994, prefacing Congress' decision to trade American sovereignty for a WTO Membership card, a Harvard Law professor testified before the Senate Commerce Committee. He cautioned, "With more than 120 Member nations entitled to challenge American laws, and with the United States deprived of any veto power over the decisions of the dispute settlement bodies, our participation in the WTO makes very real the prospect of serious economic sanctions…against which we will not be in a position to retaliate lawfully."
The recent WTO-authorized retaliations appear to lend credence to this concern. Food safety is a highly contentious issue in the European Union. On several occasions, after extensive debate, the European Union has made the political decision to ban hormone-fed beef. Yet the WTO has deemed this action illegal and authorized the US to make Europe pay a price for its democratically determined choice. The more recent GMO case will undoubtedly add more fuel to this fire.

The prospect of punitive retaliations exacerbates growing concerns about dispute panel decisions. The US, for example, has lost a fairly large number of cases leading to complaints in the US congress that the Dispute Settlement Body (DSB) is exceeding its mandate. Critics argue that when the Uruguay Round agreement strengthened the WTO dispute-settlement system it dramatically increased the dangers that the WTO rules will be determined by dispute panelists rather than WTO Members. Claude Barfield and Marco Bronckers, for example, maintain that there is now a dangerous mismatch between the speed and efficiency with which the dispute-settlement process acts and the lengthy delays associated with negotiating new rules. They fear that since the rules are unclear, this leads to excessive judicial activism on the part of the panels, which inevitably try to fill in the gaps and deal with the ambiguities created by negotiators. Such actions, they argue, undermine national democratic decision-making. Concern that the Appeals Board may go too far has led the United States and Chilean governments jointly to propose in the Doha Round negotiations that participants in a dispute be given the opportunity, where they agree, to edit the final version of any decision.

Unfair System. For WTO participants from many smaller countries, the use of the WTO system for retaliation by the world’s two largest traders simply underscores the system’s inequities. While the WTO is a multilateral organization, its enforcement system relies on bilateral retaliation. Critics contend that this places smaller countries, without much market power, in a disadvantageous position. Even when authorized to do so, countries such as the Netherlands, Ecuador and Canada have actually not implemented retaliatory responses motivated perhaps by concerns that their actions are likely to be ineffective, or that their trading partners might retaliate through trade or other means, or that they could actually do more harm than good. While the WTO may formally preserve equality among its Members by applying principles such as decision-making by consensus, and non-discrimination, in reality the dispute settlement based on retaliation makes some Members more equal than others. In the end therefore the system is based on the persuasion of power rather than the power of persuasion. It is thus inherently discriminatory against smaller economies. Those concerned about this inequity have also supported moves that would make retaliation a response enforced

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18 For a detailed account see (Deveraux, Charan 2001)
19 For a discussion of US losses see (Leibowitz, Lewis E. 2001)
20 (Bronckers, Marco C.E.J. 1999; Barfield, Claude E. 2001)
21 For a discussion see (Hudec, Robert E. 2002) (Pauwelyn, Joost 2000) and (Mavroidis, Petros C. 2000)
22 Another dimension of unfairness relates to the difficulties and costs of bringing cases to the WTO. Developing countries have complained they lack both technical and financial resources to participate fully.
multilaterally. They would also eliminate retaliation as a response in favor of requiring the violating country either to pay monetary fines or to provide a compensating reduction in other trade barriers.

**This study.** If the critics are correct, responses allowed under the WTO dispute settlement system have serious flaws and need reform. But are these concerns warranted? What should be done about them? These are the central questions this analysis explores.

This study will adopt a fairly narrow perspective, concentrating on WTO dispute settlement responses -- in particular retaliation. Other features of the WTO that have become increasingly controversial will not be discussed in detail. Some of these broader controversies reflect concerns about globalization and the WTO’s role in promoting it; some reflects narrower concerns about the manner in which the WTO Dispute Settlement System operates – in particular, questions relating to the transparency of its proceedings, participation by non-governmental organizations, and participation in decision-making. In addition, there is the question of excessive judicial activism already mentioned. While these are important issues, the focus here will be narrower.

The analysis that follows proceeds in three steps. First, it considers the guiding principles that underpin the WTO system in general and responses in the dispute settlement system in particular. Second, it examines how these principles are implemented in practice and third, it evaluates whether the concerns outlined above are warranted and considers options for reform. A summary of the major argument in this brief follows.

**Summary.** The WTO dispute system of retaliation is controversial, in part, because there are different preconceptions about how a desirable system of trade rules should operate. One relates to the nature of WTO agreements. Should the consequences of violating WTO agreements be similar to those when violating a commercial contract, or should they be like other international treaties? Prominent legal scholars can be found on either side of this debate. The “contract” view suggests that violations should be viewed in the same vain as contract breaches – i.e. as matters of concern between particular pairs or groups of members. Such breaches may require compensation, but in any case, all are best resolved between the parties concerned. Moreover, breaches may be both efficient and desirable. The “treaty” view, by contrast, suggests that violations should be seen primarily as deviations from obligatory commitments against the community at large. Absent an abrogation of the agreement, or withdrawal from the WTO, these are obligations that must be met.

A second, related, question relates to the purpose of remedies. Should allowed responses for WTO violations (such as the provision of compensation or retaliation through the suspension of concessions) be designed principally to induce compliance? Provide compensation? Permit legal breach? or simply to maintain reciprocity? Different answers lead to different appraisals of the system’s efficacy and have different implications for reform. Thirdly, what is the connection between the system for

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23 Another idea would be to give countries the ability to trade the right to suspend concessions with third parties.

24 See (Breuss, Fritz 2002)

25 For an excellent discussion of other issues see (Porter, Roger, Pierre, Sauve' et al. 2001)
negotiating WTO rules and the system for resolving and responding to disputes? Should each be decided independently, or should they be jointly determined?

The WTO Agreements are not explicit about the answers to these questions. Chapter two deconstructs the WTO rules to help determine the degree to which these preferences are reflected in the agreements. The discussion emphasizes the central role played by the paradigm of reciprocal concessions in the WTO system. Many observers, economists in particular, deprecate the notion that WTO Members make concessions when they agree to liberalize. They find it hard to take the notions of concessions and reciprocity seriously. However, as the chapter elaborates, the notions of concessions and reciprocity are well grounded in both economic and political theory.

In disputes under the DSU, the WTO employs the principle of reciprocity very precisely in allowing concessions to be “rebalanced” in response to findings of violations. Re-balancing is supposed to be equivalent to the level of “nullification or impairment” caused by the violation. Strikingly, the retaliatory response to violations resembles the response when Members apply safeguards (which do not entail illegal behavior) in several respects: Under the rules, both are selective, temporary and equivalent to the trade impeded. Likewise, retaliation in response to violations is likely to be similar in size to rebalancing when Members reschedule their tariff concessions, (although different in that it is permanent and applied on an MFN basis).

Upon close examination, the function most clearly achieved by this system is to maintain reciprocity. In addition, however, the system achieves several other goals, at the same time, although it does so imperfectly. Re-balancing simultaneously provides incentives for compliance. It also may partially compensate the plaintiff for some of the adverse effects that could arise from the violation and it permits a form of breach without further legal consequences for an unspecified period of time. But re-balancing is not properly viewed as a punitive sanction or punishment and it may not succeed in inducing compliance. It does not fully compensate the plaintiff country for the violation and thus may not lead to efficient breach. And, ultimately since retaliation or compensation are meant to only be temporary measures, there remains an obligation to comply.

This WTO method of responding to infractions also helps to encourage Members to sign agreements they believe will be beneficial. Ex post, Members are no worse off than had they not signed the agreement. Re-balancing allows the plaintiff to restore its position prior to the agreement, while the defendant will only persist in its violation if it is made better off. Re-balancing encourages an optimal amount of liberalization when Members believe they are as likely to be plaintiffs as they are to be defendants.

The WTO rules actually reflect an amalgam of the contract and treaty views. The language of the DSU makes it clear that members cannot obtain permanent exemptions from their legal obligations simply by accepting retaliation. Retaliation is expected to be temporary. In this sense the rules resemble conventional treaties in which compliance is required. However, while compliance is preferred, it is not required within a specific time limit, and thus in practice, the system provides a mechanism for breach that could be maintained indefinitely. However, as would be the case with a treaty, members who violate the rules are viewed as having not met their obligations, even when such violations have no perceptible impact on trade flows. However, as with contract breaches that do not lead to damages, violations with no trade effects do not lead to trade retaliation and in principle violators are not punished.
Chapter three explores how re-balancing becomes more punitive in practice than the theory of rebalancing might suggest. Indeed, Members have contrived to use the suspension of concessions as an instrument for sanctions rather than restitution. Even though it constrains the dollar value of trade to be covered, the WTO gives countries a free hand in selecting their targets. Countries can and do use this leeway to inflict maximum political and/or economic harm. Given the opportunity, they have levied prohibitive tariffs on politically sensitive sectors.

The Agreement on Subsidies and Countervailing Measures (SCM) has its own dispute settlement provisions. As a result, violations of the ban on export subsidies are treated differently from all other WTO infractions. In these cases, the arbitrators have interpreted this differential treatment to allow different types of responses. They have ruled that in these cases, retaliation *can* exceed the effect on the trade of the complaining Member and held that the purpose of retaliation is to induce compliance, rather simply to “rebalance” concessions. This has introduced a more punitive element into the system that accords more closely with the “treaty” than the “contract” view.

Contrary to widely held views, the revamped DSU in the Uruguay Round was not designed to make the system more punitive, but it was designed to channel into the WTO trade disputes that were taking place outside its ambit. In combination with an expansion in scope of the rules and prohibitions on the use of “Voluntary Export Restraints” this has raised the DSU’s profile. As chapter 4 demonstrates, many of the current headline disputes (and some of the retaliatory actions) have long histories. These are really old battles being played on a new field. Recent EU-US frictions on steel and beef echo similar actions prior to Uruguay Round. Similarly, the friction over the DISC in the 1970s was the precedent to FSC/ETI. US concerns with European Agricultural policies and food safety measures and European concerns with US countervailing duty and anti-dumping enforcement have a long and sorry history. The major difference is that more of these disputes and retaliations have been now been channeled through the WTO system, rather than outside it. The WTO has become “the only game in town.”

Chapter 5 argues that many of the options advocated for reforming the response to violations are flawed. As noted in the earlier analysis, the system accomplishes several functions simultaneously, and most reforms that improve the performance in one dimension worsen it in another. Eliminating re-balancing entirely, for example, would avoid protectionist responses and treat all Members equally but it would reduce incentives for compliance and could lead to violations of reciprocity. More punitive systems or those based on fines might improve compliance and monetary payments could also avoid protectionist responses and permit more precise forms of compensation, but fines could further threaten sovereignty and be difficult to implement. Confining rebalancing to compensation would avoid protectionist responses, but would be impractical because they require cooperation by the defendant. Requiring retroactive compensation for infractions could reduce incentives for delay but might also discourage countries from assuming new commitments.

The chapter presents a proposal for contingent liberalization commitments (CLCs) could improve on the current system while preserving its essential character. As part of the next negotiation round, Members would offer to designate sectors or methods for liberalization and/or compensation in the event they failed to comply with DSB.
findings. Members whose offers are accepted could not then be subject to retaliation. Instead, in the event they fail to comply, these commitments would be activated.

This CLC system would have numerous advantages. The WTO would no longer necessarily authorize retrogressive protectionist responses. Compliance incentives could be improved, particularly for trade in products dominated by countries that currently are unable to effectively threaten retaliation. By pre-announcing sectors in which liberalization might take place, Members could create a domestic constituency in each country that would lobby for compliance, motivated by the prospects of losing their protection. Unlike a system that simply required compensation with other tariff reductions, this system would not be subject to the difficulties of finding mutually acceptable concessions. Unlike a system in which plaintiffs could order the defendant to liberalize particular sectors, this mechanism of pre-selection would not violate the capacity of potential defendants themselves to select sectors and methods for liberalization. Smaller countries would no longer be subject to inequitable treatment. They would be just as able to pursue their interests as their larger counterparts. The system would preserve the essential principles on which the WTO is based. Reciprocity would be maintained: the response to violations would still be a re-balancing of concessions and Members would still have a temporary “opt-out” mechanism when experiencing compliance difficulties.

Chapter 6 concludes. Both the US and the EU need to improve their domestic systems to ensure better compliance. They should focus as much effort in ensuring they comply with the rules as they do in finding fault with each other. In addition, changes in the DSU are being negotiated as part of the Doha Development Agenda (DDA). While some proposals have focused on retaliation, proposals for major changes to the system do not appear to command widespread support.

This analysis points to four changes that merit particular attention in the DDA. First, Contingent Liberalization Commitments (CLS)s should be negotiated. This could obviate the need for retaliatory protectionist measures and provide a more equitable and less protectionist alternative to retaliation.

Second, at the end of this and subsequent rounds, the slate of retaliatory measures should be wiped clean by obtaining offsetting liberalization. As part of the agreement, for example, the US should now obtain additional concessions from the EU if the Union is still unwilling to import hormone-fed beef. More generally, plaintiffs that have previously suspended concessions should make their new offers and requests under the assumption that this liquidation will occur. They would thereby swap these suspensions for compensation through additional liberalization in the Round.

Third, an appeals mechanism should be introduced to deal with authorizations to retaliate. The need for consistent interpretations of authorizations for retaliation is no less than the need for consistent interpretations in the rest of the agreement.

Finally, export subsidy violations under the SCM should be treated in the same way as other WTO violations. There is no economic basis for distinguishing export subsidies from other trade distortions. No reason why these prohibited measures should induce a response so dramatically different from other prohibited measures. The departures from the reciprocity paradigm currently being authorized under the SCM are inconsistent with the rest of the system. There is a danger that panels could become increasingly punitive in their authorizations and undermine the system’s long run
legitimacy. When a nation complies with a WTO ruling because it is in its long interest to do so, it helps to reinforce the system’s legitimacy. While duress could achieve conformity with the rules, in the long, it could erode support for the system. Accordingly, authorized responses to export subsidies should be equivalent to the trade lost by the plaintiffs.
Chapter 2: The role of remedies in the WTO System.

There is an inherent tension when drafting trade rules. On the one hand, implementation and adjudication are facilitated by precise formulations that are explicit about purpose and clear about meaning. On the other hand, agreement and adoption are facilitated by vague formulations that are open to a variety of interpretations. By convention, major decisions made by the WTO require a consensus, and since Members often have differing views and interests, it is not at all surprising that the rules are characterized by what is sometimes called “constructive ambiguity.” The result is that agreements are subject to very different interpretations that reveal more about the perspectives of the interpreters than about the meaning of the text. This is particularly the case when those approaching the WTO have strong normative preconceptions that color their views of what the system should be. Three such preconceptions will be considered here. They relate to the legal nature of the system, the purpose of retaliation, and the relationship between the systems for negotiating the rules and settling disputes in the WTO. 26 27

This chapter starts by outlining these preconceptions. It then describes the central role played by the paradigm of reciprocal concessions in the WTO both when negotiating agreements and when responding to violations. Finally, it considers rationales for the system’s design and the degree to which the system actually accords with the preconceptions about how it is supposed to work.

Contract breaches or treaty violations? Perspectives differ radically on the nature of the WTO rules and in particular, the consequences of their breach. The WTO agreement is a treaty in the public international law sense and WTO obligations are obligations under public international law, but should the implications of breaching WTO rules be treated in a manner as similar to breaches of the provisions of a commercial contract -- albeit among countries, or should they be treated as infractions of obligations of more traditional legal codes? Leading legal scholars can be found on both sides of this debate. 28

26 Had this study focused on the specifics of panel findings, I would have emphasized a fourth perspective that relates to the very strong presumption that the GATT agreement was intended to promote a liberal trade ethos, regardless of what might have been written in the text. Robert Howse argues that this perspective heavily colored the panel findings in the case of Tuna-Dolphins. He also quotes Robert Hudec who states that GATT “rulings often expressed an intuitive sort of law based on shared experiences and unspoken assumptions.” (Howse, Robert 2000) page 39.

27 A fifth powerful notion, to be discussed below, relates to the idea that the GATT has successfully channeled mercantalist folly to the purposes of achieving freer trade.

28 Kenneth Dam, in his pioneering study of the GATT, emphasized that it was an unusual international agreement. “The fundamental decision was taken at the very beginning to refrain from the adjudicatory approach to dispute settlement.” The General Agreement contains no provision for references of disputes or questions of interpretation to the International Court of Justice. Nor is there any provision in the General Agreement for an internal tribunal to promulgate authoritative interpretations on questions of interpretation(Dam, Kenneth W. 1970) page 251. “Illegality” in the GATT is “an uncertain and ambiguous concept. Although the substantive provisions ...are drafted in conventional terms, including a rather liberal use of prohibitory language, the remedy provisions are not drawn in terms of sanctions” “A failure to respect a tariff concession is usually not regarded as transgression to be punished but rather as an event
of WTO commitments and the manner in which remedies should be applied. One side in 
this debate emphasizes the resemblance of the WTO to a commercial contract. Proponents of this view sometimes point out that Members of the GATT were referred to 
as “contracting parties.” Similarly the process is called “dispute settlement” rather than a 
trial. Those with this view would see the WTO commitments as reciprocal obligations in 
the manner of those assumed in commercial contracts. The parties agree to constrain 
their behavior because they believe it will be mutually beneficial. If, subsequently, one of 
the parties decides compliance is no longer in its interest, it can be relieved of its 
obligations by providing adequate compensation.

In this construct, the party that runs afoul of an agreement might be likened to a 
renter who breaks a lease. Such a breach is not an act of negligence, nor is it a crime or 
infraction that should be punished. Contracts are, after all, not social obligations. Breach 
is a matter between the parties and does not violate commitments to the community 
(Members) as a whole. Once adequate compensation has been provided, the promisor in a 
contract is usually fully relieved of his obligations. To be sure, his reputation and future 
credibility may suffer as a result of breach. However, if he decides that he would be 
better off by breaching the contract, and if the promisee can be left in a position that is no 
worser than had the contract been fulfilled, society benefits from allowing such breach.

Others have a very different perspective on WTO rules. WTO rules are binding 
in the same way as other international agreements. Implicitly, therefore, parties should 
comply with WTO rules even when continued performance of the agreement is no longer 
in their interest and even if their behavior has no measurable impact on the trade of other 
members. In particular, even if a losing Member provides compensation, is subject to 
retaliation, or strikes some other political bargain that leads the plaintiffs to drop their 
case, it is not relieved from the obligation to comply with the original agreement. Viewed 
from this orientation, therefore, violations are akin to statute infractions. They are 
ultimately committed against WTO Members as a whole, technically obligations are 
mutual or erga omnes partes, and not simply with Members with a direct interest in 
the matter. Some of this persuasion would like the WTO system to evolve even further in 
the direction of legalization and constitutionalization. One argument is that this would 
create greater certainty for private economic rights, broadening the institution’s purview 
from an agreement that is only among nation states. Some would like Dispute Settlement 
Body (DSB) to follow precedent and establish a common law. Some advocate responses

giving contracting parties the privilege, subject to the approval of the Contracting Parties, of suspending 
reciprocal concessions.” page 352.

29 For example (Bello, Judith Hippler 1996; Schwartz, Warren F. and Sykes, Alan O. 2002) 
30 For an argument that WTO obligations are reciprocal see (Pauwelyn, Joost 2002) 
31 See for example (Pauwelyn, Joost 2001). For a cautionary note see (Goldstein, Judith and L., 
Martin Lisa 2002) and . (Howse, Robert and Nicolaides, Kalypso 2001)
to violations that exceed the impact on the trade of a complainant, to provide for reparations, induce compliance and even punish the violator.

It is interesting that the tension between the views on the purpose of the responses to violations has a long history. John Jackson’s authoritative description of the preparatory work for the original GATT Articles XXII and XXIII notes that draftsmen had different positions. He observes.

“Domestic law analogies to these two positions might be the law of contract damages on the one hand (redressing the damage done to expectations but generally banning punitive damages) and the criminal or tort law on the other hand (whereby sanctions or punitive are authorized and not limited by the actual amount of damage caused).”

These differences in perspective may have important policy implications. In particular, those with the contract view will be more likely to see the WTO as more compatible with national sovereignty, less inclined towards punitive retaliatory responses and more willing to see a role for diplomatic solutions to conflict. By contrast, those endorsing the alternative perspective see a greater role for international legal rules and are more likely to endorse stronger and even punitive responses to infractions.

Why Remedies?

These differences come out clearly in a related dispute about the purpose of retaliation in the WTO system. Since the purpose is not spelled out explicitly in the agreement, this creates lots of opportunities for disagreement. The WTO talks in one case of allowing “appropriate countermeasures.” But what is “appropriate”? Different perspectives on the purpose of retaliation lead to very different notions of the kind of response that should be authorized. These notions heavily color both external perceptions of the WTO and arguments and judgments in WTO disputes.

Compliance. A natural presumption for some is that retaliation should be a trade sanction imposed with a view to inducing compliance. This view follows naturally if the system is presumed to be similar to other enforceable rules-based systems, such as codes of criminal law, although in principle it is also compatible with the idea of the WTO rules as a contract in which there are consequences for breach. This perspective certainly meets the political needs of the officials from a country that wins a trade dispute, but is unable to obtain a satisfactory response from the loser. It also fits naturally into the classic “Prisoner’s Dilemma” paradigm used by economic theorists which assumes that self-interested parties that could benefit from breach must be induced to comply by the prospect of punitive consequences in response to infractions.

The punitive nature of the system is generally taken for granted by those who express concerns about the erosion of national sovereignty. The complaints of Ralph

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33 SCM Article 4.10.
34 The theoretical literature usually models compliance with trade agreements as a repeated game in which each country weighs the benefits of deviating from its commitments against the costs implied by the responses of other countries. In this system, the amount of liberalization is determined by how severe and credible is the likelihood of punishment. (Staiger, Robert 1995)
Nader (cited in chapter 1) and others exemplify this view. It is also the perspective of those who experience what Steve Charnovitz aptly terms “sanctions envy” and would like their particular rules, such as environmental or labor standards, enforced by the WTO.\(^{35}\)

But there are others who argue that punishing sovereign nations is both ineffective and unnecessary. Abram and Antonia Chayes, for example, suggest that compliance with international agreements is generally preferred for three principal reasons: (a) compliance enhances efficiency by saving on transactions costs, (b) compliance occurs because treaties reflect national interest and (c) there is a widely held social norm that the law should be obeyed.\(^{36}\) An additional reason is the concern that countries have about their reputations.\(^{37}\) Breaching an agreement even when the specific costs of compliance are greater than the benefits can nonetheless do long-term damage to a nation’s ability to obtain future agreements. It could also damage its non-trade relationships with other countries.

The relationship between the severity of retaliation and compliance may not be linear. If enforcement was made too strong, and a country was to retaliate in a manner viewed as wholly disproportional this could spark (unauthorized) counter-retaliation by its trading partner and result in an escalating trade war.\(^{38}\) Thus paradoxically, another role of the system is to keep responses within bounds.

**Compensation.** A second preconception is that retaliation is meant to provide compensation for the wronged party. Indeed as I will discuss in greater detail, there are some who adopt the contracting perspective, who argue that with retaliation, the equivalent of “expectation damages” is provided to the promisee in the event of a contract breach. Viewed from a mercantalist perspective this view appears justified. If the defendant has improved its balance of trade as a result of the violation, it is only proper that the plaintiff be allowed to recoup its losses by raising barriers of its own. To be sure, there is resistance to this view by those who see mercantialism as folly and the impact of protection as harmful to the retaliating country. In particular, it is hard to square the idea that allowing the plaintiff to “shoot itself in the foot” is a mechanism for providing compensation. But as I note below, countries may indeed incur both political and economic costs in making agreements, and may reduce these costs through retaliation.

**Legal Breach.** A third and less common notion is that WTO remedies should provide a legal mechanism for countries to escape from their commitments. Members may commit to agreements in good faith but if circumstances change they may find compliance too onerous. Proponents of this approach argue that the system should allow countries to escape from such burdens under certain conditions.\(^{39}\) To be sure, these conditions should not be too lenient since this might undermine compliance. But they should also not be too onerous, since this might discourage Members from negotiating agreements in the first place.

\(^{35}\) (Charnovitz, Steve 2001)
\(^{36}\) (Chayes, Abram and Chayes, Antonia 1995)
\(^{37}\) (Kovenock, Dan and Thursby, Marie 1992)
\(^{38}\) This possibility, characterized as an “off-equilibrium path retaliation” is discussed in (Bagwell, Kyle and Staiger, Robert 2000)
\(^{39}\) See for example (Rosendorf, B. Peter and Milner, Helen V. 2001)
**Balancing Concessions.** A fourth notion is that retaliation is simply a mechanism to maintain the balance of concessions that have been negotiated through the WTO. WTO Members are presumed to accept obligations only because they have received rights in return. In particular they have agreed to reduce their own trade barriers and in return have received increased access to other Members’ markets. When a Member violates an agreement in a manner that nullifies concessions to which it has agreed, therefore, it is only fitting that others be permitted to withdraw concessions that they have made. 40

*An integrated system?* Another preconception present in many discussions of the WTO system is that the system for dispute settlement can be considered separately from the system for negotiations. Some of the concerns voiced about the system of retaliation described in the first chapter have this character. For example, some who portray retaliation as a penalty neglect to consider the fact that parties losing a WTO case have in principle reneged on an agreement in which others made concessions. As I elaborate in greater detail below, when plaintiffs retaliate therefore, they are not applying a punishment, but returning to the status quo ante the original agreement.

Similarly, those who express concern that smaller countries have greater difficulties in applying retaliation sometimes overlook that this feature of the dispute settlement is the mirror image of the advantages these same countries might enjoy from free riding in a negotiating system based on the most favored nation principle and that developing countries might enjoy from the special treatment that allows them to receive the benefits of WTO concessions without being required to make reciprocal concessions.

Those who advocate either making the enforcement stronger or weaker sometimes also fail to understand or consider that the mechanisms used in dispute settlement system will affect the negotiations system by influencing the extent to which Members are willing to liberalize in the first place. On the one hand, if the dispute system is too weak, it could discourage liberalization by raising concerns about the likelihood of compliance and the credibility of commitments. On the other hand, if it is too strong, it could also create disincentives to make commitments because of concerns of the costs of breach when circumstances change. Stronger penalties for example are presumed to improve compliance but if they put a damper on new negotiations their impact could actually be perverse because ongoing negotiations help to encourage compliance -- Members comply, in part because maintaining a reputation for compliance is important not simply to preserve existing agreements but also to extract concessions in the future.

In sum, the WTO system is complex and subtle. The merit of criticisms of the dispute settlement system and suggestions for the reform of dispute remedies will depend on the kind of legal system that should be implemented, the purposes that the remedies should serve, and the links that are desirable between the dispute settlement and negotiations systems. Thus far, however, the discussion has dealt with preconceptions about what the system should do. Let us turn now to analyze what it actually does, and then evaluate the degree to which the system actually accords with the preconceptions. 41

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40 As I elaborate below, balancing concessions is not the same as providing compensation. Compensation could be expected to leave the injured party in a condition no worse than had the agreement been fulfilled. By contract, the balance of concessions could be achieved either through providing new concessions or restoring the status quo ante.

The Reciprocity Paradigm.

The preamble to the Agreement establishing the World Trade Organization lists the goals of parties to the agreement. These include “raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand and expanding the production of and trade in goods and services.” It notes the parties’ desire to achieve these goals “by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations” (italics added). Thus WTO agreements are presumed to result from countries making concessions on a reciprocal basis. This presumption lies at the heart of what I shall term the WTO paradigm, the crucial notion that guides both agreements and dispute settlements.

Concessions. A central conception in the paradigm is that when a country agrees to reduce a trade barrier it is making a concession. Article 2 of the GATT for example is not entitled “schedules of tariff reductions” but rather “Schedules of Concessions.” This idea is fundamental to how the WTO operates. Since reducing import barriers will generally increase national welfare, economists sometimes scoff at this notion of a concession. Why should a measure that is in the nation’s interest and should in any case be adopted unilaterally be considered as a concession?

Mercantilism. Some see this talk of concessions as a brilliant subterfuge that harnesses mercantilist sentiment in the name of free trade. In this view, as vividly spelled out by Paul Krugman, the WTO tacitly accepts the naïve (and incorrect) notion that “exports are good” and “imports are bad” and therefore treats measures that increase imports as concessions. Economists sometimes rationalize playing along with mercantilist views when they see these serving a greater good. But their deeply held view that this perspective is fundamentally misguided sometimes leads them not to take certain elements in the WTO system very seriously. In particular, the idea that trade liberalization entails a concession and the idea that retaliation could actually operate as a form of compensation for the winner of a trade dispute appear highly questionable.

Terms of Trade. There are, however, alternative explanations that rest on more solid conceptual grounds. Tariff reductions will improve domestic efficiency, reducing distortions to consumption and production decisions. Under competitive conditions, therefore, if a small country removes tariffs, it will raise national welfare. However, for countries large enough to affect prices in world markets, the calculation is more complicated because tariff reductions may also worsen a nation's terms of trade. When a large country lowers a tariff barrier it increases demand for the product on world markets. This makes its imports more expensive to the country. Moreover, to pay for these

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42 See (Krugman, Paul R 1997) Krugman observes in GATT think: “(1) Exports are good; (2) Imports are bad; and (3) Other things equal, an equal increase in imports and exports is good. In other words GATT-think is enlightened mercantialism.

43 According to Paul Krugman, “If economists are sometimes indulgent toward the mercantilist language of trade negotiations, it is not because they have accepted its intellectual legitimacy but either because they have grown weary of saying the obvious or because they have found that in practice this particular set of bad ideas has led to pretty good results” page 115 in (Krugman, Paul R 1997)

44 The domestic price will equal the world price plus the tariff. When tariffs are reduced, the world price will rise but the domestic price paid by consumers will generally fall.
imports and restore balanced trade, the country will have to sell more exports abroad and this could reduce export prices. These responses will reduce the nation’s terms of trade (the ratio of export to import prices) and offset the welfare benefits that occur through the greater efficiency associated with reducing the trade barrier. Thus countries reducing trade barriers could be making “concessions” in the sense of taking actions that everything else being equal, could reduce their welfare.

Domestic politics. The third explanation is based on domestic policies. Reducing trade barriers could create losers as well as winners. With lower import barriers, consumers will gain but import-competing producers will lose. Under competitive conditions, the gains to consumers will outweigh the losses to producers. However, producers are generally well organized politically, while consumers face serious problems in acting collectively. Accordingly, policy-makers may find liberalization politically painful. From their standpoint, the creation of losers among producers who compete with imports could therefore represent a concession.

Realpolitik. A fourth explanation reflects international concerns of the Realist school of international relations. Conventionally, economists assume the goal is only to maximize absolute national incomes, but in “realist” political views, countries are also concerned with their relative incomes. Realists see states as living in an anarchic world in which competition and conflict are inevitable. The win-win character of trade which economists find so pleasing actually presents a problem from this perspective. Reducing import barriers may raise domestic incomes but it could also raise incomes abroad by more. In this framework any measure that has the risk of enhancing foreign welfare by more than it raises welfare at home, could therefore be seen as a concession.

Reciprocity. A second key notion in the WTO system is the paradigm that all concessions in the WTO are made on a reciprocal basis. What exactly does “reciprocity” mean? According to economists Kyle Bagwell and Robert Staiger

“The principle of reciprocity in GATT refers to the “ideal” of mutual changes in trade policy which bring about changes in the volume of each country’s imports that are of equal value to changes in the volume of each country’s exports.”

Thus concessions are balanced or reciprocated when they result in equal trade flows. Although it is nowhere defined explicitly, implicitly reciprocity in the WTO is thus used in a specific sense. WTO Members are not required to completely remove their

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45 For an analysis of how tariffs affect the terms of trade see (Krugman, Paul and Obstfeld, Maurice 2003) pages 195-6.
46 For a more detailed description see (Grieco, Joseph 1990) and (Stein, Arthur A. 1990)
47 A fifth reason is that by signing an agreement, (that binds tariffs at a particular level or accepts certain rules) countries are agreeing to limit their future policies, even if circumstances change. Such limitations are concessions from countries that could otherwise change their policies freely.
48 Dam recalls that the Havana Charter emphasized “no Member shall be required to grant unilateral concessions” page 58 (Dam, Kenneth W. 1970) He later notes “From the formal legal principle that a country need make concessions only when other contracting parties offer reciprocal concessions considered to be mutually advantageous has been derived the informal principle that exchanges of concessions must entail reciprocity. Page 59. Thus while the GATT does not formally require that negotiations produce balanced concessions, it is implicitly assumed that they have done so.
49 (Bagwell, Kyle and Staiger, Robert 2000) page 37.
trade barriers, nor or they generally required to have the same tariff levels, either on average or in specific commodities. Instead, as a result of each negotiation, Members are expected to give, in value, the same new trading opportunities as they receive. This is a system based on what Jagdish Bhagwati has termed “first difference” reciprocity.

Countries take their initial starting positions as given, and then establish equivalence between the levels of concessions not the overall level of trade barriers. 51

An example. The United States agrees to lower its tariffs on imports of a product -- say a particular type of industrial chemical sold only by Poland. In return Poland agrees to lower its tariffs on a product the U.S. exports -- say a particular type of computer that is only made in the US. 52 If the concessions are balanced and the lower Polish tariffs on computers result in an extra billion dollars worth of US exports, and the lower US tariffs on industrial chemicals should result in an extra billion dollars worth of Polish exports.

The value of trade induced by a tariff reduction will reflect (a) the volume of trade covered by the reduction; (c) the size of the tariff reduction; and (c) the behavioral responses these reductions will induce. In practice, however, some negotiators may never actually estimate these variables. Instead some may simply use readily available proxies such as trade coverage – the volume of trade covered by the tariff reductions – taken alone or each multiplied by the percentage reduction in the relevant tariff. Since they are incomplete, such measures may be flawed. Other negotiators may prefer not to be precise about their estimates so that they can apply different political weights to particular concessions. 53 (Maybe, to return to our example, if the US industrial chemicals lobby is strong, an additional billion dollars exports of computer exports is worth only a half billion dollar imports of industrial chemicals). Nonetheless, the idea of reciprocity through balanced concessions plays a crucial role in the WTO paradigm. Countries that consent to a trade agreement are presumed to have received “concessions” that exactly offset those that they have made. 54

Reciprocity plays an important role not only in the negotiations for new trade agreements but also negotiations for new Memberships. As Joost Pauwelyn emphasizes, the WTO is different from many other international agreements in that Membership does not simply entail a willingness to accept certain obligations in return for certain rights. 55 Acceding Members are required to make concessions when joining in order to balance the concessions that existing Members are presumed to have made.

The principle that countries are not expected to make concessions unless other nations provide them with reciprocal benefits comports with the interpretations of concessions discussed above. From a mercantilist view, if imports are bad, they should only be increased in return for additional exports. In this view, agreements that increase the trade balance are particularly good, while those reducing it are especially bad. If a

50 (Bhagwati, Jagdish 1991)
51 Ironically, the idea that agreements are supposed to be balanced does not stop politicians from implying that they will boost aggregate employment and create jobs!
52 More typically these concessions are made to several principal suppliers, and the concessions received may be from other parties.
53 (Dam, Kenneth W. 1970) page 59
54 For more on this see (Bagwell, Kyle and Staiger, Robert 2000) For skeptical views on reciprocity see the papers in (Bhagwati, Jagdish 2002)
55 (Pauwelyn, Joost 2000)
country obtains an agreement that boosts its trade balance, others must be experiencing declines. However, a system that preserves balanced trade is more plausibly fair for all.

From an economic standpoint, reciprocity takes care of the terms-of-trade problem that large countries face when liberalizing unilaterally. As Bagwell and Staiger have emphasized in a model with two large countries, world relative prices will remain unchanged if the value of increased sales of imports due to an agreement is offset by an equal value of exports. Thus negotiations based on reciprocity allow countries to set their tariffs in a manner that is desirable from a domestic viewpoint without having to worry about their terms of trade.

From a domestic political standpoint, reciprocity helps deal with the collective action problem that hinders unilateral liberalization because consumers are poorly organized. The reduction in foreign trade barriers generates support from producers in export industries that can offset the opposition of producers competing with imports. From an international political viewpoint, reciprocity appears to be a rough and ready way of ensuring that relative gains are similar.

Politically, relative gains may matter. In a bilateral trade negotiation, if nation A receives some benefits, but the benefits to nation B are perceived to be even greater, there may be a sense within A that the deal is unfair. In addition, if the other side is left with large benefits, the negotiators for nation A may face complaints that they have not done as well as they might have. Reciprocity helps quell these concerns and aids in the normally difficult relationship between negotiators (the agents) and their domestic constituents (the principals).

Making reciprocity a foundation for negotiations also has a practical side. As John Macmillan has pointed out, multilateral trade negotiations are extremely complex and there may be a wide variety of outcomes that Members may have to consider. But if the principle of reciprocity is taken as the basis of the negotiations, only those options that yield balanced trade need be evaluated. Drawing on work of Thomas Schelling, Macmillan argues that reciprocity serves as a focal point that limits potential options for agreement. He comments that even if the notion is inherently arbitrary, it serves to reduce transactions costs and thus facilitate agreement.

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56 Bagwell and Staiger (op. cit.) show that if two countries act independently, and take each other’s tariff’s as given, they will reach a Nash equilibrium that is not Pareto optimal. Each is reluctant to liberalize further because it will be hurt by the associated decline in its terms of trade. However, in a cooperative negotiation based on reciprocity, each can be sure that its trading partner’s actions will keep the terms of trade constant. This allows both countries to liberalize further and they will achieve agreement that is Pareto optimal.

57 If countries are simply maximizing domestic welfare they would move to free trade. If, for political reasons, they apply different weights to output, they may prefer to have tariffs.

58 In the formal economic explanation that relies only the terms of trade effects, there is no need for a separate domestic politics rationale for reciprocity. However, despite the very impressive theoretical accomplishment of Bagwell and Staiger there remains considerable skepticism about explanations giving terms of trade effects a dominant role particularly since these are almost never mentioned (and rarely recognized) by trade policymakers. See the discussion on the practical relevance of terms of trade considerations in Chapter 11 of (Bagwell, Kyle and Staiger, Robert 2002)

59 Actually, even if concessions are balanced in this way, the gains could be very different.

60 (McMillan, John 1988)

61 According to Macmillan op cit. “In the case of GATT talks the focal point is generally nothing more than a measure that takes into account the relative size of different countries and is simple to calculate using data that are readily available”
There are to be sure some departures from reciprocity in the WTO rules. Developing countries, in particular, are supposed to enjoy “special and differential treatment”. This principle is enforced in many areas relating to rules. Developing countries are also not expected to make reciprocal concessions. They are also allowed to obtain special preferences under the General System of Preferences (GSP) that are separately administered by developed countries and do not require reciprocal concessions. In addition, in practice, since the WTO is based on unconditional most favored nation (MFN) treatment, small countries may be able to free ride on reductions in tariffs negotiated by others.

However, basing negotiations on reciprocity also has a downside for these countries. With reciprocity what nations get is determined by what they give. It is therefore no surprise that the most significant process in reducing trade barriers have been in the products that are of concern to the developed countries i.e. tariffs on industrial products. By contrast, barriers remain significant in the agriculture, textiles and other labor-intensive manufactures that are produced by developing countries. Moreover, as I elaborate in greater detail below, the inability to retaliate is inversely related to the ability to free ride.

Violations. What role does reciprocity defined in terms of trade effects play in the response to violations? It is important to distinguish between a breach of a legal obligation or rule and the “nullification and impairment of benefits” that results from such a breach. The former refers simply to the act of violating the agreement, the latter is generally interpreted to refer to its impact on trade.

As John Jackson has documented, “originally the key to invoking the GATT dispute settlement mechanism was almost always ‘nullification and impairment’”. However, this changed over time and Article 3.8 of the DSU states “In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered prima facie to constitute a case of nullification and impairment. This means there is normally a presumption that a breach of the rules has had an adverse impact on other Members parties to that covered agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge”.

Jackson observes “this makes the presumption of nullification and impairment derive ipso facto from a violation, thus almost discarding the nullification and impairment concept in favor of a focus on whether or not a ‘violation’ or ‘breach’ of obligation exists.”

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62 The WTO Ministerial Declaration on the Doha Round, for example, states, “The negotiations shall take fully into account the special needs and interests of developing and least-developed country participants, including through less than full reciprocity in reduction commitments.”
http://www.wto.org/english/tratop_e/minist_e/min01_e/mindecl_e.htm
63 To be sure, the failure to liberalize these sectors reflects the domestic strength of protectionist forces in developed countries in addition to the reluctance of developing countries to negotiate.
64 (Jackson, John H. 1998) page 332.
65 In a case brought by Uruguay in 1962, as noted by Jackson (op. cit.) a panel argued that “any violation of the GATT would be considered a prima facie nullification or impairment”. This represented a shift in the direction of rule orientation rather than simply facilitating settlements. Jackson also notes that in 1988, in the Superfund case, the United States conceded that it had violated the national treatment provisions of Art III by imposing a higher tax on imported products. However, it tried, unsuccessfully, to have the case rejected on the grounds that the tax had had no measurable impact on trade flows. However, in that case, the panel said that such a violation created a presumption of nullification that was not rebuttable. More
Nonetheless, even if violation does create a presumption of nullification and impairment, the trade effects of the nullification play a critical role in determining the responses that are allowed because of such violations. Indeed, the manner in which the WTO responds to violations in the agreement follows quite naturally from the manner in which the agreement was negotiated in the first place. Reciprocity is not only a central principle in negotiations but also in allowed responses under the DSU. Such allowed responses, particularly retaliation, relate to nullification and impairment of benefits between the parties rather than violations of the rules in general. As Joost Pauwelyn observes, “What is actionable under the WTO is not so much the breach of obligations, but the upsetting of the negotiated balance of benefits consisting of rights, obligations and additional trade concessions.” (Italics added) 66

In sum, although reciprocity is a desired outcome and negotiations are presumed to result in reciprocity, reciprocity is not formally required in negotiating rounds. There are no officially published estimates of the trade volumes granted and received. Indeed, since WTO agreements increasingly relate to the acceptance of obligations to adhere to rules rather than to reduce tariffs, the reciprocity paradigm has less and less relevance. The agreements relating, for example, to Sanitary and Phytosanitary Measures (SPS), technical barriers to trade (TBT) do not readily fit into reciprocity framework. However, reciprocity is formalized in the responses the WTO allows other members to make when agreements are violated.

Box: According to the WTO Dispute Settlement Understanding (DSU), the parties to the dispute are first required to engage in consultation and, if they wish, to ask the Director General to mediate in their dispute. If these consultations are unsatisfactory, within 60 days, a complainant can request the establishment of a panel to hear the case. The WTO Dispute Settlement Body (DSB) would establish a panel (drawing on its roster of potential panelists nominated by WTO Members). The panel would then examine the case, and after an interim report, issue a final report with conclusions and if they so decide suggestions as to how to come into compliance. If the panel finds that a Member has failed to comply, absent an appeal by that Member, it could make a recommendation as to how its could come into compliance. If it is impractical to comply immediately, the Member would be given “a reasonable period of time to do so” (Article 21.3 DSU.). The finding could then be appealed. If the Member loses the appeal and fails to act within this period, the rules call for the parties to negotiate compensation, “pending full

recently, the US 1916 Anti-Dumping Law was held to be a violation even though it had never been applied. 66 (Pauwelyn, Joost 2000)

67 The rules for dispute settlement in the WTO build on those enshrined in Article XXIII of the GATT agreement. WTO members typically bring complaints in one of two forms. Either they allege that a specific WTO discipline or negotiated commitment has been violated or they claim that although no specific WTO rule has been violated, a government measure has nullified a previously granted concession. (a so-called non-violation complaint). There is also a catchall third possibility, a so-called situation complaint, in which a member argues that ‘any other situation’ not captured by the other two categories has led to nullification or impairment of a negotiated benefit.

68 Panel reports must be adopted within 60 days, unless a consensus exists not to adopt, or a party appeals the findings. Appeals are limited to issues of law and legal interpretation and are heard by an Appellate Body composed of seven members. Appeals proceedings must be completed within 90 days.
implementation’ (Art 22.2 DSU). Compensation is however ‘voluntary’ (Article XXII.1). Moreover, it is generally understood that any compensation provided should be on an MFN basis. 69 If after 20 days, compensation cannot be agreed, the complainant may request authorization from the DSB to suspend equivalent concessions. 70 In particular “the level of the suspension of concessions... shall be equivalent to the level of nullification and impairment. (Art 22:4) The magnitude of the retaliation is determined by the DSB, generally on the recommendation of the original panel. Arbitration, to be completed within 60 days, may be sought on the level of suspension, the procedures and principles of retaliation (Art 22.6 DSU). Conspicuous by its absence in this approach is a requirement that the violating country provide “compensation” for the trade that has been lost over the period prior to the resolution of the dispute settlement case. Adjustments have almost always been prospective. 71

If a defendant is found to have nullified its commitments, the agreement would no longer provide reciprocal benefits. How could the agreement be re-balanced? There are three ways. (1) The defendant could eliminate the regulation and come into compliance with the agreement; (2) The defendant could grant the plaintiff another concession (compensation) or (3) The plaintiff could withdraw concessions to the defendant (suspension of concession). Any of these three options could achieve a re-balancing.

The first solution, having the defendant comply with the agreement is the outcome sought by the WTO. As noted in Article 3.7 of the DSU “A solution mutually acceptable to the parties to a dispute and consistent with the covered agreements is clearly to be preferred”

If, however, immediate withdrawal of the offending measure is “impracticable” compensation (in the form of other concessions) can be provided. “The last resort …is the possibility of suspending the application of concessions or other obligations under the covered agreements on a discriminatory basis vis-à-vis the other Member.”72

Article 22 of the WTO Dispute Settlement Understanding emphasizes however: “Compensation and the suspension of concessions or other obligations are temporary measures available in the event that the recommendations and rulings are not implemented within a reasonable period of time. However neither compensation nor the suspension of concessions is preferred to full implementation of a recommendation to bring a measure into conformity with the covered agreements.”

69 The DSU Art 22:1 states “compensation is voluntary and, if granted, shall be consistent with the covered agreements” This is generally understood to require that it be based on MFN principles. See (Anderson, Kym 2002)
70 According to Art 22:3 of the DSU, the complaining party should first seek to suspend concessions with respect to the same sector as that in which the panel body has found a violation. If that party considers it is not practicable or effective it may seek to suspend concessions in other sectors under the same agreement, (if this is not practicable or effective then obligations under another covered agreement may be suspended).
71 According to (Pauwelyn, Joost 2000), “in six of the GATT panel reports that addressed either antidumping or countervailing duties against alleged subsidies (only three of which were adopted), the panel found in one way or the other that duties levied in breach of the rules had to be reimbursed.” page 337 footnote 21
72 DSU Article 3.7
Two observations on the suspension of concessions are in order. First, rebalancing restores the “balance of concessions” but it is a rough measure and does not precisely restore the status quo ante. WTO negotiations are multilateral, but suspending concessions in response to violations is bilateral or at most plurilateral and is therefore discriminatory. (By contrast, compensation is supposed to be provided on an MFN basis.) Whereas reciprocity may be diffuse, therefore, retaliation only occurs between principal suppliers to the violating Member. A country that retaliates may well rebalance its bilateral trade with the defendant country but it could well experience new inflows from third parties. Moreover, Members are not obligated to respond by raising tariffs on the same products as they originally provide concessions. Instead, they are required to consider suspension first in the sector in which the violation occurred, second, in the agreement (e.g. GATT), and only then in other covered agreements (e.g. TRIPs or GATTs).

Second, the WTO also allows countries to suspend concessions under circumstances in which there are no disputes or violations. On these occasions the principle of reciprocity again plays a key role as responses are allowed in order to maintain the balance of concessions. One example occurs under GATT Article XXVIII, which allows countries legally to modify their tariff schedules. If a country withdraws concessions it has previously granted, principal suppliers of the product in which tariffs have been raised are permitted to obtain permission to respond (on an MFN basis) with higher tariffs of their own. Clearly, in this case, no attempt is being made to compel the country to restore the tariffs it has modified. The purpose here is simply to permit the injured suppliers to rebalance their concessions. Yet the magnitude of the response is commensurate with the response to Article XXIII (nullification) violations.

A second circumstance occurs in response to safeguard actions under GATT Article XIX. (Emergency Action on Imports of Particular Products). If a Member finds that “as a result of unforeseen developments and of the effect of obligations it has incurred” imports are (or threaten to be) “a cause of serious injury” the Member may “to the extent and for such time as may be necessary to prevent or remedy such injury” suspend the obligation or modify the concession.” Again, with certain qualifications, suppliers affected by a safeguard have the right either to obtain compensation through MFN tariff reductions in other sectors or to rebalance concessions through raising tariffs discriminatorily or suspending obligations elsewhere.

The resemblances between the escape clause and GATT Article XXIII are not coincidental. John Jackson notes that in its 1946 proposal for a draft of the ITO Charter, the United States included an article on nullification and impairment. He adds, “This article was placed in close proximity to the escape clause article and discussions at the

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73 DSU Article XXII.3 (f) defines “sector” as “all goods” with respect to goods, refers to list of eleven sectors with respect to services, and several categories with respect to trade-related intellectual property rights.

74 Another important difference between rebalancing under Article XXVIII and re-balancing under Article XXII of the DSU is that renegotiations under Article XXVIII in addition to being done on an MFN basis are permanent. By contrast, suspensions under DSU Art 22 (and GATT Art 19) are expected to be temporary, and are undertaken on a discriminatory basis.

75 As a result of the Uruguay Round Agreement compensation is not required, nor a suspension of concessions allowed if the safeguard is limited to three years and if the injury results from an absolute increase in the quantity of imports. See Agreement on Safeguards.
London session indicated the opinion that there was a strong resemblance (between) the purposes of the escape clause emergency relief from obligations in cases of serious injury from imports) ...and the “nullification and impairment clause” (where expected benefits under the agreement were not materializing). 76

In both the case of rescheduling negotiations and safeguards there is obviously no punitive purpose. 77 It is significant, therefore, that if an agreement is nullified or impaired and not brought into compliance, the response is substantially of a magnitude similar to those when countries legally modify their tariff schedules under Article XXVIII of the GATT and when they implement a safeguard action under Article XIX. 78 Responses under Article XXVIII and Art XIX are both required to be “substantially equivalent” to the trade opportunities lost in response to rescheduling or safeguard actions respectively. Responses under Art 22 of the DSU are required to be “equivalent” to the level of nullification and impairment. 79

**WTO Dispute Settlement Remedies: A Deconstruction.**

When parties breach a contract they are generally required to provide compensation. This requirement actually accomplishes three tasks simultaneously. It provides an incentive for compliance by the promisor; it provides compensation to the promisee in the event of breach; and it also permits breach by the promisor if circumstances warrant. How well, then, do the remedies provided for in the WTO system meet the goals that participants generally ask of it? In particular, how successful is it as a means for inducing compliance, providing compensation, affording an escape clause and maintaining reciprocity?

All four of these goals may be desirable in practice and any system that could simultaneously achieve them all would be particularly successful. However, generally, to hit four targets, you need an equal number of instruments. If you have just one instrument, unless the targets just happened to be aligned in a particular way, some compromises may have to be made. Similarly, some trade-offs may have to be made if one mechanism – re-balancing concessions – is used to accomplish all these tasks. In

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76 (Jackson, John H. 1969)page 167.
77 Standing to retaliate also differs in these cases. For actions taken under DSU Article XXII eligibility is confined to parties that bring the case. Any substantial supplier (typically a supplier with a 10 percent share) may retaliate in response to an Art 19 safeguard. Principal suppliers, substantial suppliers and the member that originally negotiated the concession may participate in Article XXVIII renegotiations.
78 Article XXII:4 of The WTO Dispute Settlement Understanding (DSU) states that “the level of the suspension of the concessions or other obligations authorized by the DSB shall be equivalent to the level of the nullification or impairment.” Article XXVIII:4 (d) of GATT states that if a contracting party withdraws a concession, other parties can withdraw “substantially equivalent” concessions initially negotiated with that contracting party. Article XIX:3 of the GATT talks of allowing affected parties to suspend “substantially equivalent concessions or other obligations.”
79 In practice, responses to renegotiations and safeguards are undertaken on a duties-collected basis. I.E. the increase in tariff times the average trade in that item for the last three years. By contrast retaliation in response to nullification and impairment could entail more sophisticated economic reasoning. I am indebted to Amy Porges for clarifying this for me.
addition, the instruments that are practicable and available in an international setting are different from those that might be feasible domestically. In particular, there are other constraints when the parties are sovereign governments, WTO rulings have no direct legal effect on domestic laws, and force cannot be used to ensure remedies are implemented.

It should not be surprising, therefore, that several of these goals are not completely achieved. Nonetheless, rebalancing concessions in response to violations helps to improve compliance, mitigate some of the costs that violators impose on other countries, provide a legal mechanism to permit at least temporary breach of WTO rules and help ensure that reciprocity is maintained. But it does not compel (or assure) compliance. Nor does it fully compensate other countries for their losses. Its role as an escape clause remains controversial, and it maintains reciprocity fairly imprecisely and sometimes only with considerable delay.

**Compliance.** Economic theory suggests that rebalancing through the suspension of concessions eliminates the encouragement the WTO system might otherwise provide to large countries to engage in violations that improved their terms of trade. But rebalancing does not necessarily punish violations, and theory also predicts that if the internal benefits outweigh the costs, countries will violate the agreement, a practice WTO remedies do not necessarily prevent.

Suppose, for example, a tenant rents an apartment on a month to month basis (without making a security deposit) and then fails to keep up on the rent payments. The landlord responds by evicting the tenant. Has the tenant been subject to a punitive sanction? No, the landlord and tenant have both taken actions with equivalent value. It’s simply that the arrangement has collapsed, and the landlord has been able to restore the status quo ante. To be sure, the tenant is more likely to pay the rent knowing that eviction is an option so that the threat of eviction does help induce compliance. But eviction is clearly not a sure-fire method of ensuring compliance and the tenant may well prefer eviction to paying the rent.

The WTO’s “suspension of concessions” operates in a similar fashion. It has the effect of restoring the balance of concessions that existed prior to the adoption of the rule (or agreement) that has been nullified. It does not entail punishment, particularly when trade flows of similar value are assumed to be equivalent. Indeed, WTO language never speaks of sanctions or penalties. It describes retaliation simply as the “suspension of...

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80 John Jackson provides some interesting historical insights that ambivalence about the purpose of the remedies has always been present. He notes “As one surveys the preparatory work as a whole the impression develops that the draftsmen of GATT Articles XXII and XXIII had several difference goals in mind and it is not clear that these goals were consistent.” (Jackson, John H. 1969) page 169.

81 In his study of the preparatory work on Articles XXII and XXIII John Jackson notes, “It was clear that the draftsmen had in mind that Article XXIII would play an important role in obtaining compliance with the GATT obligations. The customary international law analogy of retorsion was used but throughout the various drafting sessions, there seems to have been some conflict as to the nature of the role that Article XXIII should play, particularly with respect to whether the “suspension” provisions should be limited to the equivalence of the damage done by the action of an offending state or whether they authorized more extensive suspensions in the nature of a sanction….In some statements draftsmen suggested the need for “more rigorous retorsion” if the offending action is “abusive”. Yet other statements were made to the effect that measures under the article were not “sanctions” and were not “punitive” (Jackson, John H. 1969)170.
concessions.” Moreover, it restricts the value of trade eliminated by suspension to the value of trade nullified by the violation, an amount implicitly equal to the trade value of concessions initially provided by the plaintiff.

In calculating whether or not to defect in a system without any retaliation at all, a country might only weigh the benefits and costs of defection to itself. One of the costs is the impact of the higher trade barriers on the efficiency of resource allocation. Another is the damage that defection will inflict on the country’s reputation -- which could make other WTO Members less likely to provide it with concessions in the future and which could do more diffuse damage to its international relations generally. Included in the benefits would be the perceived (political) advantages of raising trade barriers and shifting resource allocation towards favored domestic constituents. 82 In addition however, on the benefit side, for a large country, there could also be an improvement in the violator’s terms of trade. This would provide an added incentive to commit the violation. If suspending concessions were not allowed, therefore, the system could reward violators at the expense of Members that adhered to their commitments. This could actually encourage violations. To offset such a loss in its the terms of trade, the plaintiff Member would have to respond with tariff hikes of its own in a manner that reduced its imports by the same volume as its export loss valued at the original world prices. This is precisely the amount of retaliation that WTO rebalancing allows. As Bagwell and Staiger show,

“GATT’s insistence on reciprocity in this circumstance can guide governments to efficient politically optimal outcomes, since by neutralizing the world-price effects of a government’s decision to raise tariffs, reciprocity eliminates the externality that causes governments to make inefficient trade policy choices.” 83

While they may not actually be encouraging defection, therefore, the absence of punitive responses renders WTO remedies rather weak instruments for compelling compliance. Indeed, several trade theorists have come to quite negative conclusions about the role of the dispute settlement system in this regard. In models typically used in this literature, low tariff levels can result when tariffs are determined non-cooperatively provided that participants fear that tariff increases will result in retaliatory responses that lead to lower payoffs. 84 In these models, introducing a dispute settlement system which limits and delays punitive responses makes potential retaliation less likely and thus leads to less liberalization. 85 As Wilfred Ethier observes, “Trade theory focuses virtually exclusively on punishments as trigger strategies to sustain agreements for significant liberalization. (Since it does not allow for punishment) actual practice is inexplicable from this view”. 86

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82 Countries could have non-economic reasons for preferring more production (or less consumption) of a particular product. See (Johnson, Harry G. 1965)
83 (Bagwell, Kyle and Staiger, Robert 1997) page 3.
84 For an excellent survey of this literature see (Staiger, Robert 1995).
85 (Ludema, R 1990)
86 (Ethier, Wilfred 2001) page 12.
One definition of an economist is “someone who sees something working in practice and wants to know if it works in theory.” In general, nations seem on the whole to comply with WTO rules, but the absence of more punitive retaliatory responses in the WTO presents theorists with a puzzle. Dan Kovenock and Marie Thursby have posited an additional “sense of international obligation” to explain why widespread defections are not a feature of the system. They demonstrate that if the dispute settlement system increases the value of such an “obligation cost” it could serve to enhance compliance and encourage the negotiation of lower tariffs. But these benefits could be obtained from a dispute settlement system that simply rendered public judgments and without retaliation at all.

All in all therefore, it appears that WTO remedies are likely to make some contribution to compliance but the contribution is likely to be modest. When combined with the fact that in practice most Members are unlikely to retaliate and that in addition, an extensive period of time could pass prior to retaliation, the system appears particularly poorly designed for this purpose. From some viewpoints however, this is not necessarily a bad feature of the system. In particular, it implies that countries generally will comply only when they believe that compliance is in their interest. This is actually quite a healthy property for a system in which sovereign nations are meant to cooperate.

Box: These ideas can be illustrated by reference to Game Theory. Trade negotiations are sometimes modeled in game theory as a Prisoner’s Dilemma. The essence of this game is the ranking of payoffs in a game between two countries. Let C denote the home country cooperating, C* for the foreign country cooperating, D for the home country defecting, and D* for the other country defecting. Home’s ranking would be DC* > C C* > DD* > CD*. Foreign’s ranking is the opposite and symmetrical. Each side would prefer to defect, provided the other side complies. (DC*) One way of justifying this, is that such actions lead to improvements in the terms of trade. But mutual cooperation (CC*) is preferred to mutual defection (DD*). Worst of all is compliance when the other party defects. (CD*).

If the game is only played once, both parties will defect. This ensures each avoids their least desirable outcome. But if the game is played repeatedly, cooperation may become more attractive. Players will factor in the effect of defection today on the likelihood that its partners will defect tomorrow. The more the future is taken into account, and the more costly future defection is likely to be, therefore, the greater the likelihood of cooperation today.

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87 See for example (Hudec, Robert E. 2002)
88 (Kovenock, Dan and Thursby, Marie 1992)
89 See (Bown, Chad P. Forthcoming) and (Bown, Chad P. 2003) for evidence that concerns about retaliation under the GATT/WTO did affect behavior.
90 The name stems from a game in which two prisoners are each given the choice of whether to confess or not to confess. If neither confesses, they will both be convicted -- say for 2 years each. However, if only one confesses, he will obtain a lighter sentence of one year and the other receives 4 years. If both confess, their sentences will both be long (say 3 years). If the game is only played once and they are not allowed to collude, the optimal strategy is to confess. If the other prisoner confesses, the first does better to confess (3 years) than not to confess (4 years). If the other does not confess, the first still does better to confess (1 year) than not to confess (2 years). Since both think alike they both confess and do worse than if they both did not.
Robert Axelrod has conducted several contests in which players engaged in such multi period prisoners’ dilemma games. It is interesting that he found those that played tit for tat were generally the most successful in achieving the most cooperative solutions over time. If each party can be assured that if it complies, the other party will do likewise, then by complying it will raise the likelihood of the outcome of mutual compliance – an outcome it prefers to mutual defection. Conversely, parties will be discouraged from defecting if they realize that this raises the possibility that their trading partners will defect in the future. It is striking, therefore, that a system with rebalancing is in fact institutionalizing responses that are tit for tat. WTO Members do indeed interact continuously. There is reason to believe therefore that to the degree the prisoner’s dilemma model accurately captures national preferences, rebalancing will similarly lead to cooperation over time.

But the Prisoner’s dilemma assumes parties rank outcomes in a particular manner. In particular they value mutual cooperation (both do not confess) above mutual defection. (both confess). However, this may not always be the case. In some circumstances, parties may well prefer mutual defection to cooperation. For example, it could well be the case that European governments prefer to ban hormone-fed beef, even if this means facing US retaliation. Under these circumstances, the US will not be able to compel compliance by simply withdrawing equivalent concessions. More punitive responses are more likely to overcome such deadlock. But they need not. And in any case could only do so at the risk of undermining reciprocity.

Steve Charnovitz has claimed that the WTO has become more punitive than GATT. Charnovitz recognizes that the GATT dispute system was based on a “re-balancing paradigm” designed to maintain a balance of concessions. However, he claims that the legal provisions of the Uruguay Round moved away from this paradigm and established a system based on “sanctions intended to achieve compliance.” Charnovitz provides an impressive amount of evidence that among policymakers, the system is widely perceived to endorse (punitive) sanctions but his efforts to find actual textual support in the DSU and other appeals body statements for his claim that the purpose has been changed are less convincing.

While there are some subtle differences in language between GATT Article XXIII and the DSU that Charnovitz interprets to indicate that the intent of suspension has been altered, he offers no evidence that larger suspensions would now be authorized under DSU Art 22. Yet, regardless of the language used, suspension has always provided both an incentive for compliance and a mechanism for maintaining reciprocity through rebalancing. The dual function of the system as facilitating rebalancing and inducing compliance has long been recognized. As Kenneth Dam noted in his study published in 1970, “The essence of the GATT system lies not in the abstract legal relationships

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91 (Axelrod, Robert 1984)
92 (Charnovitz, Steve 2001)
created by a tariff concession but rather in the enforcement mechanism.” Charnovitz reads great significance into statement by the arbitrators in the bananas case, “we agree with the United States that the temporary nature [of countermeasures] indicates that it is the purpose of countermeasures to induce compliance.” However, it then goes on to state “But this purpose does not mean that the DSB should grant authorization to suspend concessions beyond what is equivalent to the level of nullification and impairment. In our view, there is nothing in the (DSU) that could be read as justification for countermeasures of a punitive nature.”

In fact, if retaliation is authorized by the DSB under the DSU, it could well be less punitive in the new system than it might have been under GATT. With the important exception of the way in which prohibited export subsidies are handled, 93 the magnitude of the authorizations to retaliate in response to violations are actually now more tightly constrained in the Uruguay Round rules than they were in the GATT. 94 The DSU agreement eliminated any possibilities that may have existed under GATT to allow the response to the suspension of concessions to exceed “substantially equivalent measures.” The original GATT Article XXIII that covered nullification and impairment used more expansive language. In response to nullification violations, GATT Article XXIII spoke of allowing such suspensions of concessions as the GATT Contracting Parties “determine to be appropriate in the circumstances”. By contrast, Article XXVIII (Rescheduling of Concessions) spoke of providing “substantially equivalent concessions” in response to tariff rescheduling. These differences in wording led the Legal Adviser to the Director General of the GATT to argue that in responses under Article XXIII “other factors could be taken into account.” Implicitly, therefore, the response could be greater than equivalent to the amount of trade subject to nullification and impairment by the violation. 95 However, the DSU eliminated this discrepancy and made it clear that retaliation can be no larger than the nullification and impairment resulting from the violation. 96 97 Specifically Article 22:4 of the DSU states the level of suspension ..shall be equivalent to the level of nullification and impairment”. In addition, in the GATT while retaliation was constrained, there was no mechanism for subjecting the size of such retaliation to review. 98

The DSU also established a provision allowing for binding arbitration when retaliation through suspending concessions was authorized. In particular, if a Member objects to the level of the suspension of concessions, or the principles and procedures by which they have been determined, the agreement calls for binding arbitration within sixty

93 Prohibited export subsidies are subject to a different set of rules for dispute settlement. These are contained in the Agreement on Subsidies and Countervailing Measures (SCM) rather than the DSU. For a more complete discussion of this exception, see chapter 3 below.
94 (Charnovitz, Steve 2001) claims that the WTO is more punitive than GATT. His argument is discussed in more detail in chapter 2 below.
95 For a more complete discussion see Analytical Index of the GATT pp. 696-700.
96 According to Weiss, “[The ITO Charter originally made] clear that retaliation was not to exceed the amount needed for the harm done” page 389 footnote 35. He observes that “The DSU text thus returns to the final intentions of the GATT/ITO negotiators.”(Weiss, Friedl 2000)
97 The Arbitrators in the case of EC-Bananas emphasize that the equivalence standard required by DSU Art. 22.7 is stricter than under GATT (Paras. 6.3-5).
98 (Bown, Chad P. 2002) analyses the implications of giving countries more scope for responses in retaliation to violations than to safeguards.
days, either by the original panel if available or an arbitrator appointed by the WTO Director-General.\textsuperscript{99} By affording defendants the ability to argue for limitations on retaliation, the DSU raised the possibility that these could be smaller than would have occurred under GATT.\textsuperscript{100} In sum, it is hard to square this tightening of the system in the Uruguay Round with the idea that the intention was to have a system more oriented towards inducing compliance. Finally, it is instructive to recall that under the DSU, the same procedures (of compensation and suspension of concessions) are applied to cases where members violate an agreement as when they take measures that nullify and impair benefits even when such measures do not violate or conflict with any provisions of a covered agreement.\textsuperscript{101} When nullification and impairment is found to result under so-called “non-violation complaints” the DSU agreement makes it clear that a member is not obligated to remove the offending measure.\textsuperscript{102} However, Members \textit{experiencing} nullification and impairment under violation complaints are entitled to respond in the same way under violation complaints as they are under non-violation complaints.\textsuperscript{103} This suggests that in violation complaints, responses are not designed to induce compliance.

\textit{Compensation?} The ability to retaliate in response to a violation by suspending concessions could compensate a country for losses brought about by the impact of the violation in worsening its terms of trade. However, offsetting this benefit would be the losses in efficiency inflicted by the higher tariffs. While a large plaintiff can therefore offset its external (terms of trade) losses, \textit{it cannot recoup the internal efficiency benefits it would have enjoyed had there been no violation}. In other words, it is not fully compensated for the effects of the violation and in effect the best it can do is to return to the status quo ante the original agreement. Since small countries generally face terms of trade that are fixed, retaliation may provide them with no compensation at all. Responding with increased tariffs of their own will lead to less efficient levels of production and consumption and no offsetting terms of trade improvements. Such countries will be unable to receive any compensation at all.

Warren Schwartz and Alan Sykes have undertaken an interesting analysis of the WTO system using the economic theory of contract remedies. They note that in an efficient enforcement system

\textquote{\ldots a party will be induced to comply with its obligations whenever compliance will yield greater benefits to the promisee than costs to the promisor, while allowing the promisor to depart from its obligations whenever the costs of compliance to the promisor exceed the benefits to the promisee.}”

One mechanism for doing this is the award of what are termed “expectation damages” that place the promisee in as good a position at it would have been if the

\textsuperscript{99} DSU Articles 22:6 and 7
\textsuperscript{100} Indeed, in the Canada-Aircraft II (22.6) Brazil requested authorization for countermeasures against Canadian aircraft export subsidies valued at $3.36 billion. The Arbitrator eventually authorized $247.9 million.
\textsuperscript{101} For an elaboration of this distinction see (Hoekman, Bernard M and Kostecki, Michel M. 2001) page 75.
\textsuperscript{102} DSU Art 26 1 (b) states “ where a measure has been found to nullify or impair benefits under, or impede that attainment of objectives, of the relevant covered agreement without violation thereof, there is no obligation to withdraw the measure.”
\textsuperscript{103} Art 26 1 notes that in cases of non-violation “the procedures in this Understanding shall apply”…
promisor had performed. 104 If the promisor is obliged to make the promisee no worse off than she would have been had the contract been fulfilled and is nonetheless willing to break the contract, then breach is efficient.

Schwartz and Sykes claim that the WTO provisions respecting the settlement of disputes over breach of obligations are carefully designed to facilitate efficient social adjustments to unanticipated circumstances. But the WTO system is not actually efficient in this sense. By allowing victorious plaintiff countries to rebalance their concessions through suspension of concessions, the WTO does not actually provide them with “expectation damages.” 105 As already noted, the DSU states (Art 22:4) that “the suspension of concessions should be equivalent to the level of nullification and impairment”. To be sure, taken at face value, this language is compatible with an interpretation that suggests full compensation for the plaintiff, but that does not happen in practice when the statement is taken to refer to trade volumes rather than welfare. Rebalancing trade volumes leads to equivalence only in a mercantilist sense of allowing the plaintiff to eliminate the bad of imports. If politicians are concerned only about the trade balance, they may feel compensated but in terms of economic welfare, only (external) harm done to the plaintiff country due to the decline in its terms of trade can be taken care of by suspension. If it retaliates, the plaintiff country will not be compensated for the (internal) efficiency losses that will result from its higher tariffs. Instead of being in the position it would have been had the agreement been implemented, the plaintiff will find itself in the position it was prior to the negotiation that resulted in the agreement.

It is therefore not certain that the outcome is efficient in the sense that the benefits to the defendant exceed the costs to the plaintiff. The basic problem with drawing the analogy between the WTO and a system of contracts is that with contracts, payments for damages are assumed to involve “lump sum” financial payments that have no additional impact on resource allocation. By contrast, tariff changes do.

The analogy also fails to capture how tariffs actually work. The more money a plaintiff receives in compensation, the better off he will be. But any increase in a tariff beyond optimal levels could actually make the plaintiff worse off. There is an inherent limit therefore to the amount of compensation that can be provided through higher tariffs alone. If the WTO were to institute an efficient system based on “expectation damages” that operated through suspension, in addition to permitting the plaintiff to retaliate, the system would have to require additional compensation equal to the efficiency costs incurred by the plaintiff when retaliating by raising its border barriers. This would have to involve the defendant supplementing such action with financial considerations or some other side-payment. 106 Alternatively, if the WTO did not allow for suspension of concessions and could compel defendants to compensate plaintiffs with reductions in other barriers to their exports, the system could come closer to achieving expectation damages.

104 They state “expectation damages thus deter inefficient breach, because the promisor will not wish to violate and pay expectation damages unless the promisor gains more from the breach that the promises loses, in which case the breach is inefficient” page 4.
105 Actually it entails restitution i.e. the equivalence of getting the promisee’s money back in the event there is breach.
106 If the system required for punitive tariffs in retaliation, it could force the defendant to take account of the additional efficiency losses incurred by the plaintiff. However, such tariffs would not be optimal from the standpoint of the plaintiff.
It is also noteworthy that the rebalancing allowed by the WTO is prospective. Plaintiffs receive no consideration for the losses due to violations that they may have suffered prior to authorization. The obligation violated by the FSC came into effect in 1995, yet Europe was authorized to retaliate only in 2002. Clearly, this practice could render the compensation provided by the WTO system seriously inadequate. This practice may be explained by the desire to attract participants to make agreements in the first place. Indeed the best way to think about this WTO approach is as analogous to a money-back guarantee. “Buy our product” proclaims the advertisement, “and if you’re not satisfied, you can return it at any time, and you will get your money back”. Suppose you buy the product, find its performance wanting, return it and you get your money back. You have been compensated in the sense that you are back to the status quo ante. But you are not left in as good a position as had the product actually worked, and you are not compensated for the transactions costs, inconvenience and forgone interest you might have earned on your money. Similarly, when a country is given permission to suspend concessions in response to nullification of an agreement it is able to restore the status quo prior to the agreement. But it is not left in as good a position as had the agreement been fulfilled.

This analogy also points to a consideration that could detract from the inducement to sign an agreement in the first place. If transactions costs are significant, you will be less impressed by a simple money-back guarantee. If your trading partner is unreliable, and these costs are significant, you will be less likely to sign in the first place. When these costs are large therefore, compensation would have to be larger.

Let’s illustrate some of these points with the example of the United States and Poland. Assume that originally, the United States and Poland each set their tariff levels independently. (Assume both are large countries) Taking American tariffs as given, Poland did the best it could when setting its computer tariffs and the United States likewise set its tariffs on chemicals at their optimal levels taking Polish tariffs as given. At that time, each was prevented from reducing its tariffs further by the adverse effect on its terms of trade. By negotiating a reciprocal agreement, however, they managed to eliminate this effect, and the United States agreed to reduce its tariffs on chemicals in return for a reduction of Polish tariffs on computers. They were now able to move to a new situation in which both were made better off. However, circumstances changed for the United States (or it misunderstood the terms of the original agreement) and it chose to nullify the agreement, in effect raising its protective barriers back to their original levels. Assume now after winning its case at the WTO and being granted authorization Poland retaliates. Trade barriers have now reverted to the original situation. The United States persists with the violation. Apparently, circumstances have changed and the United States no longer wants the deal.107 By revealed preference, therefore, the United States is better off without an agreement. If circumstances have not changed for Poland, however, it is now worse off than it was with the agreement. Poland has clearly not been fully compensated for the breakdown in the agreement, but its retaliation has at least allowed it to offset the worsening in its terms of trade that resulted from the US violation. Poland is no worse off, though, than had there been no agreement in the first place.

107 In this case, the original Nash equilibrium is also Pareto optimal and the best deal that can be sustained without making one of the parties worse off.
Strictly speaking, therefore, allowing for suspension, removes the additional incentive that the terms of trade improvement would otherwise provide for violations. It also allows Poland to offset the loss it would otherwise experience from the decline in its terms of trade due to the violation. But Poland is not as well off as it would have been had the US stuck to the agreement. What rebalancing through suspension does therefore is to expunge the impact of the agreement and allow the system to revert to the status quo ante. Benefits are “rebalanced” in the sense that neither side benefits from the agreement.

In sum, breaches that occur through this mechanism will not necessarily be socially (or globally) efficient, since the gains to the violator could be less than the costs to the plaintiff. Nonetheless, setting compensation at a relatively low level could have the desirable effect of encouraging those Members that are fearful that they may have breach to sign agreements in the first place. However, Members who believe that breach by the other side is likely may be less willing to sign than if they believed the other side would suffer more serious consequences. In particular, if the transactions costs of signing agreements are substantial the failure to provide adequate compensation could also serve to discourage agreements by some Members.

Safety-valve? We have seen that WTO remedies have weak effects in inducing compliance and do not require full compensation of loss for the plaintiff. Paradoxically, however, these features actually enhance the system’s ability to provide a safety-valve mechanism.

Safety valves are useful. Modification of Schedules (Under GATT Article XXVIII) and escape clause actions under GATT Article XIX (Emergency Action on Imports) are generally viewed as desirable attributes of the WTO system. Both are designed to assuage the legitimate concerns Members may fear that circumstances could change after they have signed an agreement. Rescheduling (GATT Art XXVIII) permits Members permanently to opt out of tariff concessions that they no longer view to be in their interests. Escape clause actions (Art XIX) permit a Member to obtain a temporary respite from its obligations in the face of unforeseen developments. By providing these mechanisms, the system encourages Members to make concessions they would not otherwise make and to avoid commitments that no longer serve their interests. Yet similar provisions for “escaping” from other types of WTO obligations appear to be conspicuously absent. For example, what if a country finds its adherence to the TRIPs (Intellectual property rules) provisions unexpectedly causes serious injury? What if a Member is genuinely surprised to find that its understanding of a particular provision is different from the ruling giving by the WTO Dispute Settlement Body? Under these circumstances, a Member may find that its preferred option is to violate the agreement and deal with those who complain through the dispute settlement system.

It has already been noted that the suspension of concessions allowed by the WTO in response to violations is substantially similar to that allowed in response to “escape clause” actions and rescheduling under Article XXVIII. The resemblance between suspensions under (DSU) Article XXII and (GATT) Article XIX is particularly strong, since both are expected to be temporary. This suggests that de facto, accepting retaliation in response to findings of violations may provide an escape clause route for circumstances not covered by Article XIX. More controversial is the question of whether
accepting such retaliation could serve as a more permanent opt out mechanism similar to Article XXVIII.

Legal scholars are divided over the precise nature of the obligation to comply with the rulings of the Dispute Settlement Body. The DSU language clearly states that compliance is “preferred.” It also states that rebalancing through either compensation or suspension of concessions is meant to be temporary. Unlike tariff re-schedulings, the suspension of concessions under Article XXII of the DSU is undertaken bilaterally rather than on an MFN basis, reinforcing the idea that this departure from a basic WTO norm is meant as a temporary measure. In addition, there are provisions that require the DSB to keep such cases under surveillance. According to John Jackson therefore, ultimately the obligation to comply is the same as any other binding obligation under international law.108 Scholars such as Judith Bello, Warren Schwartz and Alan Sykes provide an alternative view. They place more significance in the phrase “compliance is preferred” and argue that it is significant that the phrase “compliance is required” is never used.109 They also emphasize that although rebalancing is meant to be temporary, there are no specific time limits placed its exercise.

As an economist who lacks legal training, it lies beyond my competence to choose between the eminent legal authorities on this issue. However, I would note that the practical significance of the argument about an ultimate requirement to comply is relatively small. Although the application of remedies is “intended to be temporary” the practical effect of not providing for a firm date for compliance could be to allow the defendant legally to sustain the practice indefinitely.110

The potential benefit of such a mechanism for indefinite breach has increased as the dispute settlement system has become increasingly powerful and the scope of WTO rules increasingly broad. It is no surprise that the agreements contain gaps, ambiguities and inconsistencies. Yet it is not easy to change them. Negotiating new agreements has become increasingly time-consuming. Even if the Doha round ends as scheduled in 2005, for example, twelve years would have passed since the end of the Uruguay Round. The Dispute Settlement Body, (DSB) by contrast, now acts fairly rapidly. Its cases must meet time guidelines and Members cannot prevent the Appeals Body from issuing binding rulings.

In a recent study, Claude Barfield argues there is now a mismatch that inevitably produces excessive judicial activism. “The internal flaw is between the WTO’s consensus-plagued inefficient rule-making procedures and its highly efficient dispute settlement system—an imbalance that creates pressure to “legislate” new rules through adjudication.”111 The ability to reverse rulings, which in domestic settings is provided to the legislature, is not effectively present in the WTO. Barfield is concerned, therefore, that the preferences of sovereign national governments will be overridden by DSB

108 The DSU Art 22:9 also states “When the DSB has ruled that a provision of a covered agreement has not been observed, the responsible Member shall take such reasonable measures as may be available to it to ensure its observance” This seems to reinforce the principle of a legal obligation to comply. But it also states “The provisions relating to compensation and suspension of concessions or other obligations, apply in cases where is has not been possible to secure such observance.”

109 (Schwartz, Warren F. and Sykes, Alan O. 2002)

110 To be sure, the DSB does monitor uncorrected violations permanently.

111 Article IX:2 of the WTO Agreement states “only the Ministerial Conference and General Council are empowered to adopt definitive interpretations of GATT-WTO texts.”
interpretations. The result of this imbalance will inevitably be an erosion of the WTO’s legitimacy.

Barfield’s cites five cases to bolster his arguments. While his judgments about whether panels have exceeded their mandates in individual cases can be questioned, what is indisputable is that many WTO cases are extremely controversial. Passions are bound to be inflamed when the WTO makes rulings on hot topics such as the relationship between the trade rules and the environment (tuna/dolphin) and (shrimp/turtle), food safety (e.g. beef-hormones), non-transparent barriers (Kodak-Fuji), US anti-dumping provisions 112 tax subsidies (FSC/ETI.) and now GMOs.

How then should the WTO respond? One approach would be to weaken the dispute settlement system. Indeed, Barfield’s solution to this problem is to create mechanisms for short-circuiting and/or blocking the dispute settlement process. Specifically, he advocates two changes to create “a less rigid, more flexible dispute settlement system” 113.

But it is by no means clear, however, that the system would be improved by adopting Barfield’s recommendations. They could actually prove counterproductive. Imagine the cries of foul if, as Barfield advocates, the Director General of the WTO (or a subset of WTO Members) unilaterally made the decision that a dispute was too controversial or political, or that the language agreed upon by a consensus of WTO Members was too vague, for the DSB to render a judgment. One can well imagine those who believe they have the upper hand in the dispute complaining vehemently that their rights were being overruled by an unrepresentative group of Members or even worse a bureaucrat like the Director-General of the WTO. Likewise, it is hard to imagine that a victorious litigant would look favorably at a decision being overruled by a blocking minority of Members—his second recommendation. Adopting these suggestions might not only reduce the WTO’s legitimacy, but they would impair its efficacy.

Moreover, the proposition that it is better to have agreements that are never authoritatively interpreted is highly questionable. Panelists perform valuable services both in providing interpretations and in signaling where clarification and amendment is called for. If countries could no longer be sure that the dispute settlement system would be able to make rulings on violations, they would be less likely to rely on it. This could mean less liberalization. It would also lead to an increase in extra-WTO retaliation and thus reverse one of the great accomplishments of the Uruguay Round Agreement.

The argument here suggests that the WTO already has in place a mechanism to deal with the concerns raised by Barfield. Countries that lose cases, as with the EU and Beef-Hormones, need not give up the sovereign right to determine their own laws. If they do not wish to comply with DSB rulings they can either pay compensation or accept retaliation. They can then try to have the rule changed or clarified in the next trade round. De facto, therefore, the responses to violations under the DSU operate as an escape clause, although this is not generally acknowledged. As long as retaliation is restrained, perhaps it is sufficient to simply allow this mechanism to serve tacitly as an escape clause mechanism. However, if responses are increasingly allowed to follow the more punitive approach and reasoning used in the FSC case discussed in chapter 3, there may be pressures for a provision, analogous to Article XXVIII for rescheduling tariffs,

112 See (Leibowitz, Lewis E. 2001)
that could be explicitly invoked, in the event particular rules become untenable. In both cases, other Members could respond by rebalancing their concessions.

Rebalancing? This review of three possible goals of WTO remedies suggests some role for each. However, these attributes appear as by products of a system that is best explained as an effort to maintain reciprocity through rebalancing. John Jackson in his study of the preparatory work done for the original GATT and ITO quoted one of the drafters as stating, “what we have really provided, in the last analysis, is not that retaliation should be invited or sanctions invoked, but that a balance of interests, once established, shall be maintained.”114 Similarly, in writing about the original GATT agreement, and its responses to violations, Robert Hudec observed

“The key value underlying this rather odd legal design was reciprocity. The legal procedures were not there to enforce obligations for the sake of enforcement. They were there to correct imbalances that might arise in the benefits government’s were actually receiving from the agreement. It was a diplomat’s concept of legal order.”115

This approach appears desirable when viewed from a mercantilist perspective. If a country reneges on its promise to provide the “good” of more exports for its trading partner, the partner should either be compensated with other exports or be able to protect itself by reducing the “bad” of its imports from that country by an equal amount.

Rebalancing, as we have seen, also accords with the ideas of trade theory. By rebalancing the plaintiff is able to eliminate any deterioration in its terms of trade that might have resulted from the violation of the agreement. Rebalancing therefore ensures that countries make their trade policy on the internal consequences of their decisions and denies them the ability to shift their costs onto their trading partners.

Rebalancing also serves some important political functions by maintaining reciprocity. If producers of exports are hurt as a result of foreign violations, at least import-competing producers can be rewarded by the retaliation. Rebalancing also allows the claimant nation to prevent foreign countries from reaping extra gains from a trade agreement that it violates (an important consideration for realists); and, finally it ensures that the terms of the bargain cannot be abridged unilaterally without consequences. This gives agreements greater credibility. All these elements are important in maintaining political support for the system.

**Agreement and Enforcement: Interdependent Arrangements.**

It is well recognized in economics that barriers to exit can create barriers to entry. Just as restrictions on firing workers, for example, can discourage firms from hiring workers, so could penalties discourage countries from agreeing to WTO disciplines in the first place. This is important because one role of the WTO system is to entice the parties to sign as many agreements as possible. As Kenneth Dam noted in his classic study of the GATT,

“The GATT has a special interest in seeing that as many agreements for the reduction of tariffs as possible are made. Enforcement of tariff bindings is important .but..a system that made the withdrawal of concessions impossible would tend to discourage the making of concessions in the first place. It is better for example, that 100 commitments should be made and that 10 should be withdrawn than that only 50

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114 Quoted by (Charnovitz, Steve 2001) page 801.
115 page 7. (Hudec, Robert E. 1993)
commitments should be made and all of them kept."

Our analysis of WTO remedies suggests that the WTO system operates by offering parties close to a “no lose” or “get your money back opportunity.” If the deal looks beneficial today, you can sign it knowing that at worst, if circumstances change, you cannot be worse off. After all, you will only defect if you think defection makes you better off. However, if your trading partner defects, you will be able to rebalance concessions and at worst, revert to the status quo ante, raising your tariffs to their previous level, which is the best you can do given the other side’s violation. Even in this case, assuming there are no fixed costs associate with signing the agreement, (and no delays in enforcing it) you will not be worse off than you would be without an agreement, because you will have enjoyed benefits until the violation was committed.

On the other hand, suppose that, instead of simply allowing the plaintiff to return to the status quo ante, the rules allowed it to exact an additional penalty. This could make the breaching party worse off than it was prior to the original agreement. Its terms of trade would end up lower than before the agreement and thus the “externality” from breach would now be negative rather than positive. Assume that prior to the agreement, the plaintiff had set its tariffs at their optimal level, given the absence of an agreement. If they were then required to impose a penalty, they too would be worse off from participating in the agreement. While such penalties might be more effective in inducing compliance, if they failed to do so, both parties could be worse off and hence discouraged from entering into the agreement in the first place.

In the discussion of compensation it was noted that once an agreement is signed, the provision allowing retaliation to be equivalent to nullification and impairment does not lead to optimal breach. However, it can be shown that the provision can lead to optimal agreements being signed in the first place. Wilfred Ethier has argued persuasively that rebalancing with commensurate responses is an optimal approach when countries negotiating trade agreements are subject to considerable uncertainty about whether or not they could find themselves out of compliance. “Each country knows that it might turn out to be either the accuser or the accused. Thus it is in no country’s interest, ex ante, to agree that, ex post, either the accuser should be unconstrained in its ability to punish or the accused should be unconstrained in its ability to proceed without punishment.” He argues, therefore, that there is a central role in the process of multilateral liberalization for an implicit agreement to allow countries to violate agreed commitments if the violation implies no retreat from reciprocity. He also demonstrates rigorously that a system with commensurate responses to violations leads to an optimal degree of liberalization.

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116 This assumes there are no fixed costs associated with signing the agreement.
117 Assume that the original negotiations began with a “Nash” equilibrium. Both sides were not cooperating and each side set its tariffs at the optimal level given the tariffs in the other country. In this framework therefore, if the violation restored the defendant’s tariff to its original level, in the absence of its WTO commitments, the complainant would respond by raising its tariff back to its original level as well. It would not want to respond with an even higher tariff. Thus rebalancing accords with the response the defendant would chose on its own.
118 Ethier, Wilfred 2001 page 5.
119 An important assumption in proving this result is that verdicts are rendered rapidly so no weight is given to the adjudication phase. Lengthening this phase will lead to less liberalization. Either also derives conditions in which commensurate responses remain optimal. Page 20 Ibid.
In sum, the ability of plaintiffs to suspend concessions in response to WTO violations accomplishes several goals simultaneously. Above all it permits the plaintiff to maintain reciprocity. In addition, it reduces incentives for non-compliance, it offsets some of the losses the plaintiff incurs from the violation; and it may provide a (temporary) “safety-valve” mechanism that permits breach. The system also encourages Members to enter into new agreements—indeed it will lead to the optimal amount of liberalization.120

The failure to appreciate that each of these considerations plays an important role in the system can lead to misplaced criticism and poor advice. For example, those who claim that WTO retaliations are sanctions forget where WTO agreements come from in the first place. WTO agreements reflect concessions. When countries are found in violation, they have in principle reneged on something for which they received consideration. When plaintiffs retaliate therefore, they are not applying a punishment, but returning to the status quo ante the original agreement. Similarly, it is true that smaller countries have greater difficulties in applying retaliation. But in part this is the mirror image of the advantages they could enjoy from free riding in a negotiating system based on the most favored nation principle.

The mechanisms used by the dispute settlement will influence what can be negotiated. For example, the WTO implicitly assumes that Members have acted in good faith. When findings of violations are made, remedies are always only prospective. This certainly weakens compliance incentives because it implies that there might be no consequences for temporary violations, but it may also help facilitate agreement, by giving countries assurances that they will not be punished if they misunderstand the agreement.

The system of negotiation also helps to drive compliance. Members comply in part because maintaining a reputation for compliance is important not simply to preserve existing agreements but also to extract concessions in the future.

When critics propose reforming the system, they often fail to consider the impact of their recommendations on the other roles. It is certainly possible, for example, to improve compliance with stronger penalties, but this could come at the expense of the other goals. Stronger penalties would disturb the balance of reciprocal concessions given by Members, inhibit Members from exercising breach and (in mercantilist terms) provide “excessive” compensation. Similarly, more lenient responses might allow Members to breach their agreements more easily but this would again disturb reciprocity and reduce incentives for compliance.

**Conclusions.** At the start of this chapter I laid out three sets of preconceptions the observers bring to the WTO. These concerned the legal nature of the system, the purpose of remedies, and the links between the systems for obtaining and enforcing agreements. This discussion of the system’s guiding principles and rules suggests that nuanced judgments of the degree to which the system actually accords with these preconceptions are warranted.

The system has several attributes that resemble a contract. Agreements reflect deals struck by Members on the basis of mutual interests, rather than global statutes enacted through legislative decisions. Responses to violations are treated as a matter between the affected parties, and not as infractions against the organization as a whole. Members, rather than body as a whole bring cases. If participants in a dispute are able to

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120 (Ethier, Wilfred 2001)
strike a bilateral deal that is acceptable to those affected by an infraction by offering compensation, Members can maintain their non-compliance without further economic consequences. If they are not able to obtain satisfactory compensation, plaintiffs are not entitled to impose punitive responses and do not even receive expectation damages. Nonetheless, the analogy to a contract remains imperfect. Those who violate a contract may be able to obtain permanent relief from their obligations by providing compensation. However, even when compensation is provided, WTO Members cannot permanently evade their (legal) obligations to comply. Ultimately WTO obligations are the same as those of any legally binding international agreement. “Suspension of concessions” or compensation are in principle only temporary measures. However, because there are no time limits placed on breach, the infraction could be maintained indefinitely without further consequence. Moreover, by buying off plaintiffs with compensation prior to a judgment, Members can avoid incurring such an obligation in the first place.

While WTO remedies achieve several goals simultaneously, the goal achieved most precisely is maintaining reciprocity. The suspension of concessions does operate to create an added inducement for compliance. It may provide larger Members with the ability to offset losses in their terms of trade. In practice, by accepting retaliation a defendant may escape from its obligations, temporarily in principle and indefinitely in practice.

Finally, a key feature of the system is that agreements and enforcement are integrally linked. Conceptually, the principle of reciprocity guides both the manner in which agreements are reached and the remedies that result from violations, although in practice, reciprocity is enforced more precisely when concessions are suspended than when they are granted. Operationally, responses to violations reinforce the ability to obtain agreements by providing recourse but avoiding punishment. Conversely, the need to maintain credibility in ongoing negotiations reinforces compliance with dispute settlement rulings.

Nonetheless, while the paradigm of reciprocity fits neatly into a framework in which concessions relate to border barriers, it does less well when relating to rules. In particular, WTO Members are obliged to adhere to rules and violation of rules creates a presumption of “nullification and impairment.” However, when faced with violations, other members cannot seek compensation or authorization to retaliate unless they can demonstrate that they have experienced nullification or impairment of benefits, that is, trade effects. Thus the system is actually a strange hybrid in which the response to violations of obligations to adhere to rules that have no impact on trade flows differs from the response to violations that affect trade.
Chapter 3: Practice makes imperfect.

The previous chapter brought out the central role of the idea of reciprocity in WTO agreements. Indeed, the assumption that the Members have all made reciprocal concessions is basic to the mechanisms used to obtain agreement and to resolve disputes. This paradigm, like many myths, plays an important role in revealing some central truths and in guiding actions. As with other myths, however, it glosses over other important considerations. This may lead to implementation problems with results that may deviate from the system’s essential principles.

As noted in the previous chapter, when a Member is found to have nullified an agreement and fails to come into compliance, absent suitable compensation, the injured parties are entitled to retaliate. In response to violations subject to DSU provisions, countermeasures taken by suspending concessions must be “equivalent to the level of nullification and impairment.” This, according to legal authority Petrus Mavroidis “makes it plain that there is no room for punitive damages in the WTO context.”

Nullification is in turn understood to reflect the amount of lost trade. Perceptions. In practice, however, the WTO has allowed this provision to become a mechanism for inflicting harm. One reason is that this is what the parties think they should be doing. Despite the care with which the WTO Agreement has been worded and tightened, there is a widespread view that the WTO system allows for punitive sanctions. Parties rarely use the phrase “suspension of concessions” and more commonly, belligerently refer to such actions as “sanctions” or “retaliation.” Indeed, Steve Charnovitz has marshaled an impressive list of trade experts and officials, including WTO arbitrators, who refer to these measures as sanctions, supporting his claim of widespread perceptions that these provisions are meant to force compliance.

Remarkably, in its own official publication, the WTO states “Even once the case has been decided, there is more to do before trade sanctions (the conventional form of penalty) are imposed.” (italics added)

Circumstances. A second reason is that the withdrawal of concessions comes in the aftermath of a violation finding compounded by a failure to implement a remedy. It is natural, under these circumstances, for injured participants in particular to believe that the violator should be punished. Simply re-balancing concessions certainly does not bring much satisfaction to those who have been denied market access. For example, the ability to retaliate against the European Union in response to prohibitions on US beef imports might restore the United States to a balanced position but it does nothing to compensate US Beef exporters for their lost sales in Europe. It is of little comfort to the National Cattlemen’s Beef Association that the US can use the violation to help other industries that have had difficulties competing in international trade. They may take greater comfort, however, if there is at least some evidence that the Europeans are being punished for their violations. Accordingly, retaliating Members are naturally belligerent and angry when announcing measures and are served by being able to portray them as sanctions. In addition, plaintiffs will naturally adopt a belligerent attitude in an effort to

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121 (Mavroidis, Petros C. 2000).
122 (Charnovitz, Steve 2001)
123 Trading Into the Future http://www.wto.org/english/thewto_e/whatis_e/tif_e/disp1_e.htm
persuade the other party to comply. The WTO paradigm treats WTO Members as unitary actors. In reality, Members represent domestic actors who have differing interests and are not indifferent among concessions in different products, even if they have equal dollar values.

*Discretion.* When it comes to selecting the sectors in which re-balancing will occur, parties typically design their strategies to maximize the incentives for eventual compliance. (Although they may also use the opportunity to favor and protect domestic firms) 124 The approach followed in retaliations for beef, bananas, and FSC is to select a number of import categories whose value sum to the total allowed and then subject them to one hundred percent (or even prohibitive tariffs). 125 The idea is to completely eliminate trade in the chosen sectors to fully utilize the value of retaliation allowed.

Thus the perceptions of penalties are not entirely mistaken. In principle, Members are simply rebalancing concessions but WTO procedures allow parties to retaliate in whatever way they chose, as long as the total value of trade involved is equal to the value of trade involved in the violation. These procedures give injured parties considerable flexibility, both in the method that will be used to determine the value of trade lost, and in the products that will be singled out for retaliation. 126 There appear to be no customary or official analytical guidelines for Article XXII.6 calculations (Compensation and Suspension of Concessions). Disputants submit their respective methodologies to arbitrators, who have full discretion on how to incorporate (if at all) those techniques into the final calculation. In most of the cases that have been brought so far, the arbitrators relied heavily on the methodologies submitted by the parties. The onus has been on the defendant to prove that the approach used by the plaintiff is inappropriate. 127

*Measurement problems.* It is often difficult to be precise about how much trade would be affected by a violation. Conceptually, as noted above, to measure the impact of a trade barrier such as a tariff requires an estimate of (a) the volume of trade subject to the tariff; (b) the size of the tariff; and (c) the behavioral responses that are likely to result from such reductions. In the case of a tariff, the size of the tariff will be known but there could be considerable uncertainty associated with the other parameters. In particular, if a tariff is prohibitive the volume of imports could be zero. In such cases it becomes

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124 If they were simply maximizing their aggregate national welfare, countries would presumably try to impose optimal tariffs. (See (Krugman, Paul and Obstfeld, Maurice 2003) page 223-224). They would select products in which the tariff’s incidence would fall mostly on foreigners since domestic demand was relatively elastic and foreign supply was inelastic. But as the newspaper quotations below indicate, this is not what they appear to do in practice, suggesting that political considerations play a more important role in the selection process.

125 In the proposed EU retaliation for US steel tariffs, the EU has mirrored US tariffs of 30 and 15 percent. (Inside US Trade.)

126 The understanding on rules governing dispute settlement (Art 22) requires that the complaining party should first seek to suspend concessions in the same sector as that in which the violations has been found. But it also states if the complaining party “considers that it is not practicable or effective” to suspend concessions or other obligations with respect to the same sector “it may seek to suspend concessions or other obligations in other sectors under the same agreement; or under another covered agreement.”

127 According to the Arbitrator in EU-Bananas this practice reflects the presumption that “WTO members, as sovereign entities, can be presumed to act in conformity with their WTO obligations”. The act at issue is the US proposal to suspend concessions. Since the EC is challenging its conformity, the onus is on the EC to prove it is inconsistent with the DSU. (WT/DSU/ARB/ECU page 8.) However, as described below, in Canada-Aircraft the arbitrators rejected the Brazilian proposal and provided an alternative.
necessary to estimate counterfactual sales by another method. In addition, estimates of behavioral responses have to be made using econometrics and different specifications, samples and estimation techniques could yield different results. In principle, results could also be very different depending on the competitive structure of the market. Finally, as Mavroidis points out, what the country actually “loses” is domestic value-added. In products containing imported inputs, therefore, the aggregate trade measure is an overstatement of the loss. 128

Added complications arise when the violations involve violations of rules. The paradigm of reciprocity makes sense when referring to border barriers such as tariffs and quotas in which there is at least in principle, a relatively straight-forward relationship to some amount of trade. To be sure, as long as no precise measure is required, it is possible to sustain the myth of reciprocity when it comes to agreements. “Country A gave up its right to apply non-scientific regulations in return for country B giving up its right not to protect intellectual property.” But serious problems arise when precision is required for the purposes of providing trade equivalents to be authorized for retaliatory purposes. The European ban on hormone-fed beef did not provide insurmountable obstacles since it simply banned trade that had previously existed. But suppose Europe decides not to allow imports of agricultural products containing GMO’s. Suppose the WTO declares this to be a violation of the rules. Deciding on the appropriate value of trade could be extremely difficult.

Divergent opportunity cost. As noted, simply requiring that suspension and violation be of equal dollar value does not ensure in practice that the violating country will be indifferent between them. Economic theory points to the importance of the opportunity cost of such losses. The WTO paradigm treats trade flows with equal value as commensurate. In reality however, the dollar value of trade may give little guidance as to the welfare benefits and opportunity cost associated with any particular transaction. For example, denying access to the US market for a standardized product, say oil, from one country, say Nigeria, may have almost no impact on the revenue Nigeria can earn from its exports. Since oil is highly fungible, in response to such a barrier, Nigeria could simply sell the oil to other markets and displace producers who would then make up the shortfall in the US. All told the world price of oil is likely to be unaffected. By contrast, if the US were to deny access to beer that was produced in Canada especially for the American market, Canadian producers could find their earnings seriously reduced. Given leeway to exploit these considerations, countries could retaliate to violations with a low opportunity cost using sanctions on sectors with a high opportunity-cost. Although this might preserve the appearance of equivalence the reality could be very different.

While much of the discussion focuses on the value of trade that is subject to retaliation, the height of the tariffs obviously affects the size of their impact. In the cases of beef, bananas, and FSC countries have employed, or threatened to employ, extremely high tariffs. In essence, the intention is virtually to obliterate an allowed value of trade. Until it reaches prohibitive levels, the social welfare cost of a tariff rises by the square of the rate, so that unless the original violation also took the form of a ban (as it did in beef-hormones), this form of retaliation is likely to be far more costly socially than the original violation. Plaintiffs clearly want to make sure that will they get their money’s worth. They therefore want to be sure that the reduction in trade will be no less than the assessed

128 (Mavroidis, Petros C. 2000).
value of the violation. They also want to be seen to be effective in imposing the measure. This could lead them to impose tariff increases that are far greater than reductions that could plausibly have been provided as concessions in earlier trade negotiations.

_Divergent political impact._ In addition to the economic impacts, the political effects of singling out particular sectors could be very different. Press reports make clear that these considerations have played an important role in the products selected. According to the Wall Street Journal, 129

“The European Union is making plans to retaliate against President Bush's recent imposition of steel tariffs by hitting the Republican Party where it hurts the most: at the ballot box. The EU is preparing a list of U.S. imported products valued at $2.1 billion annually that could be hit with heavy tariffs. Among the items on the list: Harley-Davidson motorcycles, Tropicana orange juice, and textiles and steel products. Many of the targeted industries are concentrated in states such as Florida, Wisconsin, Pennsylvania and West Virginia, which Mr. Bush battled for in his narrow election victory in 2000. These states figure prominently in the White House's effort to retain control of the House of Representatives in the fall elections.”

The article also notes

“The Clinton administration retaliated in its banana spat with Europe by slapping high tariffs on a very specific list of high-end items including Louis Vuitton plastic handbags from France Pecorino cheese from Italy and cashmere sweaters from Britain. British Prime Minister Tony Blair raised such a fuss over the cashmere that President Clinton later took it off the list. Among the EU’s largest targets (in the steel case) is the U.S. textile and apparel industry, overwhelmingly concentrated in the Southeast, particularly the Carolinas. Mr. Bush easily carried most of this region, but it is a battleground in the fall elections for control of Congress.” Also “Other targeted industries are concentrated in states such as Florida, Wisconsin, Pennsylvania and West Virginia, which Mr. Bush battled for in his narrow election victory in 2000”

_In practice_, therefore, countries often think and talk as if they are inflicting maximum pain rather than simply rebalancing concessions”. Since they are given the flexibility to select virtually any product they chose, countries have wiggle room to design their rebalancing actions in a manner that creates the greatest economic and /or political cost and thus exact the maximum retribution allowed.

_**Legal interpretations: The exception that proves the rule.**_ Another source of implementation problems is differences in interpretation. One of the achievements of the Uruguay Round was to ensure that disputes regarding almost all WTO rules be subject to the rules and procedures laid out in the Dispute Settlement Understanding. Prior to this agreement disputes under the several Tokyo Round codes were subject to different rules than those involving agreements in the GATT. The discussion thus far has concentrated

on the DSU that covers all but a few kinds of infractions. In the Uruguay Round Agreement, however, *distinctive provisions* were made for disputes under the Agreement on Subsidies and Countervailing Measures (SCM). Under this agreement, export (and local content) subsidies are expressly prohibited.

Disputes over export subsidies have become particularly controversial. WTO Members have actually sought and been granted WTO authorization to retaliate in three cases, a Canadian challenge of Brazilian subsidies for aircraft exports (Brazil-Aircraft) the European challenge of the United States FSC tax provisions (U.S.-FSC) and a Brazilian challenge of Canadian aircraft export subsidies. (Canada-Aircraft II).

Recall that under the DSU the language limits the suspension of concessions to a value of trade. Article 22:4 of the DSU states that "The level of suspension of concessions...shall be equivalent to the level of the nullification and impairment.” This is generally interpreted to mean that plaintiffs can only take measures that reflect the amount of trade they have lost. However, the SCM provisions relating to export subsidies use different language. Article 4(10) of the SCM allows Members to take “appropriate countermeasures” in response to export subsidies. It also notes these are meant to be proportionate.

This is clearly different from the DSU language that refers to measures that are “equivalent”. But what is to be understood by the term “appropriate”? Also in what sense should the countermeasures be proportionate? Proportionate to the dollar value of the subsidy? Proportionate to the impact of the subsidy on trade? Or proportionate to the gravity of the transgression? Given the very different preconceptions that are held about the WTO system, in particular the contrasting perspectives of those who view WTO violations like contract breaches and those who regard them as violations of obligations to the community, this wording seems designed to cause trouble, and it has.

Article 4.10 of the SCM in which the term “appropriate countermeasures” appears, has a footnote 9 that one might have hoped would clarify the term. But it has in fact, served only to increase confusion. The footnote reads “This expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under the provisions are prohibited.” The first reaction of most people who read this footnote is “huh?” It is as clear as mud. The trouble comes from the murky relationship between the first and second parts of the sentence. What exactly does it mean? There appear to be at least three entirely different responses.

The first is to assume that the phrase “in light of” is simply an awkward way of saying “despite.” This gives rise to an interpretation that would align responses to the SCM with those of the DSU. Indeed, this is how legal scholar Petrus Mavroidis appears to read it. Mavroidis acknowledges greater ambiguity as to the level of countermeasures against illegal subsidies. The term in the SCM is “proportionate” whereas in Article XXII DSU the term is “equivalent.” He notes that the footnote states that proportionate is “not disproportionate” and argues that the only reasonable

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130 In response to actionable as opposed to prohibited subsidies, according to Art 7.10 of the SCM, the countermeasures should be “commensurate with the degree and nature of the adverse effects determined to exist.” It would appear that in this case, although treated separately from the DSU, the responses allowed are similar to those under the DSU in that they are confined to be equivalent (or commensurate) with the adverse impact on the amount of trade affected. Although in this case, some might a question whether it is only the trade of the plaintiff.

131 (Mavroidis, Petros C. 2000)
interpretation of the term is that **punitive damages are to be excluded.** There could be “small deviations” but “the benchmark must be the damages suffered.” In this interpretation, because it is more difficult to estimate the impact of subsidies on exports, some additional leeway is granted in coming up with the value of suspension to be authorized, but basically it should be commensurate with the impact on trade.

A second approach would be to admit that the footnote is basically unintelligible and decide to ignore it. This is reaction of the arbitrators in Brazil-Aircraft. They observe that “it seems difficult to identify how the second part of the sentence, in light of the fact that subsidies dealt with are prohibited, relates to the first part of the sentence”. Although they are inclined to believe that “the reference to the fact that the subsidies dealt with are prohibited can most probably be considered more as an aggravating factor than as a mitigating factor.” They deliberately chose not to draw any conclusions as to the meaning of the footnote.132

It is therefore both surprising and startling that to the arbitrators in United States-FSC the meaning of footnote is crystal clear "This footnote effectively clarifies how the term appropriate is to be interpreted." 133 They exemplify a third approach. They emphasize that a proportionate response does not require exact equivalence. They state "we receive more guidance in the final part of the footnote in the use of the term "in light of" that the final part of the footnote is a matter that must enter into consideration at all times. **It is an element that is to pervade or color the whole assessment.**" In other words, they claim that the purpose of the footnote is actually to allow responses that are relatively large and certainly not limited to the trade effects. As Joel Trachtman has perceptively pointed out to me, their interpretation would have been virtually the same had the term “not” been dropped from the first part of the footnote!

On the basis of this interpretation, in the FSC case, the arbitrators decided to allow the one plaintiff, the European Union to suspend concessions equal to the full value of the FSC subsidy – the $4 billion amount sought by the European Union. The United States had argued that the European response should be confined to the effect of the subsidy on European trade and claimed that this was equal to about $1billion. 134 However, the arbitrators rejected the argument that “trade effects” should necessarily guide the response to the violation. They argued that “the unlawful character of the subsidy upsets the balance of rights and obligations irrespective of what might be, as a matter of fact, the actual trade effects on the complainant.” Indeed, the arbitrators make the very strong claim that “the United States’ breach of obligation is ..an *erga omnes* obligation owed in its entirety to each and every Member. It cannot be considered to be “allocatable” across the Membership”.135

Notwithstanding their decision to ignore the footnote, the arbitrators in Brazil-Aircraft had actually come to a similar conclusion. They also decided that the “appropriate countermeasures” they were willing to authorize for Canada did not have to

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132 However “we note ..[the footnotes]… at least confirm that the term appropriate in Articles 4.10 and 4.11 of the SCM should not be given the same meaning as the term equivalent in Article XXII of the DSU.

133 Page 11.

134 The US argued that estimates of the trade effect using economic models are unreliable. The US was therefore prepared to use the $4 billion cost of the FSC as a proxy for the aggregate trade impact. Since Europe accounts for just over a quarter of world trade, the impact on its trade should be placed at about a quarter of the FSC cost.

be confined to the loss of Canadian aircraft sales that might be attributed to the subsidies. They rejected Brazil’s argument that measures in excess of Canada’s trade losses due to the subsidies would be “disproportionate.” Indeed they too rejected the idea that the retaliation need be commensurate with the level of nullification and impairment. Instead they authorized Canada single-handedly to suspend concessions against Brazilian exports in an amount equal to the full value of the subsidy, voicing concern that a countermeasure based only on the actual level of nullification or impairment might have less or no inducement effects. As a result, “the subsidizing country may not withdraw the measure at issue.” Clearly, the view here is that when export subsidies are involved, the purpose of countermeasures is to induce compliance.

The arbitrators in this case claim that “A countermeasure becomes punitive when it is not only intended to ensure that the State in breach of its obligations bring its conduct into conformity... but contains an additional element meant to sanction the action of the state.” This interpretation of what is punitive provides a fascinating example of a slippery slope: instead of using the value of trade lost as a basis for assessing what is punitive, it implicitly uses the cost of compliance to the plaintiff. Suppose that before it would agree to remove its $4 billion FSC subsidy, the US would have to be threatened with the loss of $10 billion worth of exports to the EU. Under this notion, an award to obliterate all such trade would not be considered punitive!

In Canada-Aircraft, Brazil sought permission to take countermeasures worth $3.36 billion. Brazil based its petition on estimates of all the contracts won by Bombardier, the Canadian aircraft company, in which the illegal subsidies had been provided and in addition sales of services and parts that might have been expected. However the Arbitrators accepted Canadian arguments that countermeasures of this magnitude would be disproportionate particularly when compared to the other two cases in which countermeasures were authorized. The arbitrators therefore chose to follow the prior two cases and use the amount of the subsidy as the basis of its authorization. They estimated this at $206 million. However, they deemed it appropriate to add an additional twenty percent to reach a level of countermeasures which can reasonably contribute to induce compliance”. Accordingly they authorized suspension of $248 million. The arbitrator decided to adjust the level of countermeasures “by an amount which we deem reasonably meaningful to cause Canada to reconsider its current position to maintain the subsidy at issue in breach of its obligations”. Why twenty and not forty percent? Is this arbitration or arbitrariness? With considerable understatement, the arbitrators concede, “that such adjustments cannot be precisely calibrated”. Indeed. While measures such as the trade effects and the value of subsidies are subject to uncertainty, they are at least grounded on an objective basis. If individual panels feel free to arbitrarily add premiums,  

136 “We read the provisions of Article 4.11 of the SCM as special or additional rules. In that framework there is no legal obligation that countermeasures in the form of suspension of concessions or other obligations be equivalent to the level of nullification or impairment” (page 17).”
137 Contrary to Article 3.7 of the DSU, Article 4.7 of the SCM Agreement does not provide for any alternative than the withdrawal of the measure once it has been found to be a prohibited subsidy. Footnote 50. /WT/DS46/ARB.
138 Brazil only covered sales after the date on which the subsidy should have been withdrawn.
and their decisions are not subject to appeal, it is only a matter of time before wildly different and inconsistent approaches are adopted.

According to these views, therefore, when it comes to export subsidies, the WTO has implicitly moved away from the paradigm of reciprocity that guides the rest of the agreement. “Export subsidies are different because there is no reference to their trade effects in the SCM.” Individual Members may undertake responses in excess of the value of trade they have lost. 139 When export subsidies are involved, violators should not have a mechanism for legal breach. Moreover, the institution is apparently allowed to permit individual Members, if they choose, to try to compel compliance, either on their own behalf (as in Canada-Aircraft) or on behalf of the Members as a whole (United Sattes-FSC).

In these cases, therefore, there has clearly been a shift away from the paradigm of a contract in which violations are regarded as breaches toward a model in which violations are treated as “crimes.” And the experience illustrates the dangers in such a change in approach. To be sure, it should meet the approval of those who would like WTO rules to be more like statutes. It accords with the ideas of those who would like the WTO to play a larger role in inducing compliance. However, it also gives more credence to those who argue that the WTO has established a different and more powerful legal order than GATT and therefore represents a greater threat to national sovereignty. It also highlights inequalities among WTO Members, with some able to act as enforcers, while others cannot and it creates considerable dangers of authorizations that get out of hand.

The moralistic outrage expressed by the arbitrators in these cases may or may not have a legal foundation – again as an economist I choose not to judge the legal merits of their reasoning. But subjecting export subsidies to this unique treatment basically has little economic merit. Export subsidies can indeed distort trade, and affect many third parties, but so too do other trade barriers such as tariffs. In fact Bagwell and Staiger actually model tariffs and export subsidies as a continuum.140 It does require some economic modeling to estimate the impact of a subsidy but the requirements are not necessarily more burdensome or the results less reliable than those for modeling the effects of tariffs.

To be sure, export subsidies are expressly prohibited in the SCM, but many other forms of trade-distorting behavior are also expressly prohibited by WTO rules. For example, export performance requirements are prohibited in the TRIMs. Likewise the most fundamental WTO rule the requirement to provide MFN treatment unless otherwise provided for (as in Art XX). It is hard (or perhaps impossible) to explain why a distortion of the free market due to a performance requirement should result in a response that is radically different in size and purpose than a distortion of the free market by an export subsidy.

Shifting the basis for retaliation in the WTO from re-balancing concessions to “inducing compliance” fundamentally changes its character. It is certainly not a shift that

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139 In both cases there was only one plaintiff. What if there had been more than one? Under these circumstances, both arbitration panels indicated they would have been prepared to use trade effects in order to divide up the full amount of retaliation among the plaintiffs.

140 They point out that while a tariff-liberalization agreement expands the volume of trade, an export-subsidy reduction agreement restricts the volume of trade and argue that GATT rules against export subsidies “may represent a victory for exporting governments at the expense of importing government – and world –welfare” (Bagwell, Kyle and Staiger, Robert 2002) page 11
should be made without an explicit affirmation of this purpose by the Members. When legal scholars draw such qualitatively different implications from the same language it is surely an indication that it’s time to go back to the negotiating table.

The SCM could certainly be interpreted in a manner that basically brings it into conformity with the WTO paradigm outlined above. (as in the Mavroidis interpretation discussed above). But the arbitrators in all these cases have chosen differently. They have all argued that there is no reason to confine responses to trade effects, the purpose of retaliation is to force compliance, and, in Canada-Aircraft, introduced what under most views, would be considered a punitive element. These views are a fundamental challenge to the reciprocity paradigm analyzed in chapter 2.

The United States was a major supporter of the need for a separate agreement for disputes in the case of prohibited export subsidies. This suggests that the US felt the likelihood that it could fall foul of this provision was small. It is ironic therefore that it now finds itself subject to retaliation that is far larger than would have occurred under the DSU rules.

This development could also be seen as the exception that proves the rule. If the SCM language really does imply a different degree of illegality for infractions involving export subsidies, it could actually provide support for the view that when it comes to other infractions, the contracting view is more tenable, since these other violations are not expressly prohibited.

It is as yet unclear as to whether the expansive reading given by these arbitrators will be emulated. Rulings in individual WTO cases do not establish binding precedents. However, at a minimum, these recent cases reveal an important flaw in the dispute settlement design. The decisions of arbitrators, who are generally the original panelists involved in the case, are final and cannot be appealed. This raises the distinct possibility that cases will not be treated consistently. It also suggests that in the Doha Round the Members should clarify whether they really intended the mechanisms for dealing with export subsidies to be sui generis and whether they agree with the very expansive notion of retaliation that the arbitrators have endorsed.

In sum, the WTO system is not designed to be punitive. In practice, however, there are clearly elements of punitive behavior. These result for several reasons. First, the dispute settlement system is widely understood to involve penalties. Second, for understandable political reasons, the language associated with rebalancing is often belligerent. Third, in practice countries have tried to exert the maximum pressure the system allows by seeking to impose the most politically painful forms of retaliation the overall value that is authorized allows. Fourth, the WTO rules give Members considerable discretion in selecting the manner in which they will retaliate; Fifth, there are numerous problems in measuring the trade effects of measures that result in nullification and impairment and finally, in the case of the SCM, particularly unclear language has allowed the adoption of an expansive interpretation that is a radical departure from the rest of the system.
Chapter 4.

Imperfect Practice in the Only Game: The US-EU Trading Relationship

The Only Game in Town. Before moving to a discussion of disputes between the US and the EU it is useful to reflect on why the WTO dispute settlement system has recently become so controversial. This development is perhaps puzzling since the Dispute Settlement Understanding (DSU) negotiated in the Uruguay Round is based on the same principles as the GATT Article XXIII that governed disputes for almost half a century. Both the DSU and GATT Article XXIII have been interpreted to authorize the creation of third party panels to decide disputes when consultations failed. In the face of a violation that was not corrected, both could result in retaliation (technically the “suspension of concessions”) if defendants failed either to come into compliance or to provide compensation through reducing other barriers. To be sure, some of this recent friction undoubtedly reflects more widespread general concerns about globalization; and some reflects concerns that have been raised about the broadening of the WTO’s scope and mission. But much of it reflects a reaction to the perception that the dispute settlement system itself has been made significantly more punitive, powerful and thus more threatening.

This perception is however subject to qualification. In fact, if retaliation is authorized by the DSB under the DSU, it could well be less punitive in the new system than it might have been under GATT. The DSU also established a provision allowing for binding arbitration when retaliation through suspending concessions was authorized. In particular, if a Member objects to the level of the suspension of concessions, or the principles and procedures by which they have been determined, the agreement calls for binding arbitration within sixty days, either by the original panel if available or an arbitrator appointed by the WTO Director-General. By affording defendants the ability to argue for limitations on retaliation, the DSU raised the possibility that these could be smaller than would have occurred under GATT.

The GATT system was indeed weak, not because of the size of the responses it could authorize, but rather because of the difficulties of obtaining such authorization in...
the first place. Participation in dispute settlement was essentially voluntary because defendants were given veto power by the requirement that consensus be achieved before cases could be launched and/or findings adopted. Moreover, there were no time limits on the various stages of the proceedings, so even when they agreed to participate, defendants could use delaying tactics to stall the process. Finally, if they lost a case, defendants were under no obligation to explain how they intended to come into compliance.

But these weaknesses induced, or at least provided an excuse for, Members to resort to extra-legal gray measures such as voluntary export restraints and unauthorized retaliation. Under the GATT, so-called Voluntary Export Restraints (VERs) were often used as a substitute for official safeguard measures. Instead of formally raising their trade barriers at home, countries chose to “persuade” their trading partners to “voluntarily” restrict export volumes. In addition, prior to the Uruguay Round Agreement, the United States, in particular, undertook numerous retaliatory trade measures outside the GATT. In these cases, the US acted unilaterally, not simply determining that retaliation was warranted, but also in determining the value of the trade involved.

The DSU strengthened the WTO process in numerous respects. Most significantly, defendants could no longer prevent cases from being heard and/or panel rulings from being adopted. Under its new “negative-consensus” rule, the DSU requires consensus to prevent or suspend proceedings -- a provision that gives plaintiffs the ability to insist that cases proceed. The WTO now provides countries with the unstoppable

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146 Until the end of the Tokyo Round, defendants could prevent dispute panels from being impaneled and reports from being adopted. The Tokyo Round agreement prevented defendants from vetoing cases bought under the dispute settlement procedures for Codes such as Subsidies and Government Procurement although they could still veto cases brought under the GATT. In both types of cases, though, a consensus was still required for reports to be implemented. This rule allowed defendants to prevent reports from being adopted.

147 According to Robert Hudec, even though under the GATT defendants were able to block the adoption of adverse rulings, the great majority of rulings were adopted, and even when adoption was blocked, there was often a satisfactory correction of the practice at issue. Hudec finds that in its first three decades, the GATT achieved almost a 100 percent success rate. In the 1980s, the rate dropped, but still remained high at 81 percent. (Hudec, Robert E. 2002) page 82.

148 There was also no appeals process. If panels gave poor decisions, they could not be challenged. As Robert Hudec observed, “blocking adoption was the only form of appeal there was.”

149 Bagwell and Staiger make the interesting point that with VERs, the country restricting trade provides rents to the exporting country and thus does not enjoy a terms of trade gain. (Bagwell, Kyle and Staiger, Robert 2000)

150 See (Bhagwati, Jagdish and Patrick, Hugh 1990)

151 The largest of these was probably the levy of a ten percent tariff across the board on all Japanese exports in 1971 – clearly a violation of the United States’ MFN commitments. In addition, in 1987 the United States imposed 100 percent tariffs on $300 million Japanese exports to the US based on a unilateral determination that Japan had broken the semiconductor agreement. In 1987, the United States imposed duties and restrictions on $105 million imports from Brazil, and imposed sanctions against Brazil and India under its 301 and super 301 measures. In 1989 the US raised tariffs on European exports in its dispute over hormone-fed beef. See (Bayard, Thomas O and Elliot, Kimberly Ann 1994)

152 The United States justified its actions on the grounds that many important trade barriers were not covered by WTO agreements, and the dispute settlement system was weak.

153 An important question relates to the practical significance of these changes. Under the GATT, a guilty defendant could prevent adoption of a finding, under the DSU it cannot. But this difference is unlikely to
ability to obtain WTO judgments and blessing for suspending concessions in response to violations. \(^{154}\) And in the Uruguay Round Agreement, Members explicitly agreed to abstain from Voluntary Export Restraints.

The changes made in the Uruguay Round have therefore raised the DSU’s profile and made it the focal point of international trade conflicts. *Paradoxically, the very weakness and ineffectiveness of the GATT served to channel frictions and retaliation elsewhere.*\(^{155}\) While the GATT itself may have appeared more stable prior to the Uruguay Round, therefore, the trading system as a whole was more likely to be disrupted. \(^{156}\) It is significant, for example that since the founding of the WTO, the US has not unilaterally implemented trade retaliation under section 301. Instead, it has brought such cases to the WTO and sought authorization to retaliate. The WTO has now become the preferred locus for 301 retaliations.

From the standpoint of having international commercial relations subject to the rule of law, channeling these frictions into the WTO is a positive change. But it also subjects the WTO as an institution and the Dispute Settlement System to considerably more political pressure. This development has dramatically increased the impact that frictions between the US and the EU can have on the system -- the topic to which this study now turns.

The United States and the European Union are by far the world’s largest traders. An astounding 70 percent of all world merchandise trade involves the US or EU as either a buyer or a seller. Given these large domestic markets, they both have significant bargaining power in their trading relationships, with one another and with other trading partners. And they both have incentives to use this power. Defensively, as large players, they are vulnerable to adverse terms of trade impacts when liberalizing unilaterally. Offensively, by offering market access as an inducement, they are the most likely to obtain concessions. Both lead to an emphasis on reciprocal trade negotiations.

The EU and the US are both tough and demanding trade negotiators. This is, in part, the result of divided governmental systems. In the US case, the President has to continuously court the US Congress, because of its constitutional power over trade policy. In the EU, although the Commission has authority over external trade, the interests of national governments need to be accommodated. Neither can afford to back down in a fight. Both invest in their reputations for toughness.

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\(^{154}\) The DSU also set time limits for each stage of the proceeding; established an appeals body (AB) staffed by expert panelists to review decisions on questions of law; required losing parties to explain how they would come into compliance and provided for arbitration to determine permissible retaliation

\(^{155}\) Writing in 1987, William Davey observed “In GATT’s early years, retaliation was rare and seldom serious. It has been on the upswing in recent years. Although done without GATT authorization, it has often occurred in connection with GATT-related disputes between the United States and the EC, particularly those where panel decisions have not been adopted.” Quoted in (Jackson, John H., Davey, William J. et al. 1995) page 370.

\(^{156}\) This point is also made by (Schwartz, Warren F. and Sykes, Alan O. 2002).
Yet, for the most part, both sides have overriding interests in sustaining and promoting their flourishing bilateral economic relationship. Both sides are also aware that their conflicts could spill over and damage an international system in which their interests are even greater. Conversely, when they are prepared to agree, much of the world will be inclined to follow. Indeed, the Uruguay Round was as protracted as it was, not because over a hundred nations were engaged in the negotiations, and not because these covered 15 different areas, but ultimately because the US and the EU could not reach agreement over agriculture.

Inevitably, however, the relationship has also been marked by disputes. Some of these reflect simple misunderstandings and are amenable to resolution. Others, however, reflect deeply rooted differences in economic policies. The key challenges for such disputes are resolution and containment: on the one hand, agreement should be reached where it is possible; on the other, escalation should be prevented where there is deadlock. Unfortunately, preference for the former has often eclipsed the latter.

In a sense, the long history of EU-US trade friction anticipated the “imperfect practice” that now plagues the WTO. Far from rhetoric couched in terms of concessions and reciprocity, EU-US battles have been suffused with the language of retaliation and counter-retaliation. Threats and actions have been structured to do the most political damage – both in the sectors targeted for retaliation and the level of the relevant tariff. What is new, however, is that as a result of the Uruguay Round’s creation of the “only game in town”, conflicts and the subsequent retaliatory responses are now channeled through the WTO to a much greater extent. In the past, as noted the ongoing battles between the United States and the European Union found many other outlets, from gray-area measures like voluntary export restraints to negotiated compensation packages. The creation of a binding dispute settlement mechanism in the WTO necessitated the prohibition of many such alternatives, and the EU-US relationship is now often shoehorned into a single channel – the DSB.

This combination – imperfect practice in the only game in town – is worrisome, particularly given the intransigence of both the European Union and the United States. The disputes between the United States and the European Union at the WTO that have resulted in actual or threatened retaliation are not new. Indeed, all were present prior to the Uruguay Round – quarrels over EU agricultural and food policies, over US steel and tax policy.

The most egregious example of this intransigence is the EU agricultural policies. The European Union has been unwilling to make major changes to its Common Agriculture Policy (CAP) even when faced with retaliation. The CAP lies at the heart of the European bargain and is a lynchpin of the Union. It has not been possible to make major changes in the terms of that bargain merely because of external pressure. Other knotty problems reflect fundamental policy differences. Food regulatory systems in the EU and US are markedly different. In particular, an independent

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157 I do not mean to imply all bilateral disputes have been channeled through the WTO.
158 In this case, the game between the US and EU is not actually a classic prisoner’s dilemma in which both sides prefer cooperation to mutual defection. Indeed, it is more like the game known as “deadlock” in which one side prefers mutual defection to cooperation. For an analysis applying game theory to trade conflict including that between the US and Europe see (Conybeare, John A. C. 1987)
regulatory agency, the Federal Drug Administration, has managed to retain the public’s confidence in the United States. By contrast, European consumers are far more mistrustful of their food regulators in general and biotechnology in particular. The European Union has therefore sought to restrict imports of genetically-modified organisms and hormone-fed beef, invoking the precautionary principle.\footnote{under which crops and food can be banned until it is scientifically proven to be harmless.}

Another basic policy clash is lodged in differing tax regimes. Countries in the European Union have territorial tax systems. Firms headquartered there only pay European taxes on their European earnings. In contrast, the US system is global and firms headquartered in the United States pay taxes on their global earnings (with a credit paid to foreign governments). In low tax countries, therefore, European firms will have an advantage, an advantage the United States has sought to redress with a special tax break for its exporters – Foreign Sales Corporations.

Finally, there is steel and the administered protection policies of the United States. In both the United States and the European Union, the steel industry has been a perennial source of problems. In Europe, governments have provided direct financial support for failing firms. In the United States, by contrast, administered trade protection has been the major mechanism of support, with the United States employing countervailing duty, anti-dumping, and safeguard actions to challenge European steel imports. This in turn has led Europe to question the manner in which such protection has been applied.

Although they may have taken new forms, these issues have all been remarkably persistent. The dispute over bananas is an echo of past grievances over the CAP. The WTO-authorized retaliation over beef replicates similar US retaliation outside the GATT. European responses to FSC mirror the responses to an earlier similar US tax provision the DISC in the 1970s. Recent European threats over US steel safeguards trod the footsteps of the early 1980s. A more detailed examination of each of these disputes reveals the extent to which domestic politics has trumped international trade agreements since the 1960s.

I. Agriculture

The E.U. Common Agriculture Policy (CAP) has a long history of flaunting trade agreements in the eyes of the United States. While the United States has avoided challenging certain key provisions of the CAP (for example, it has never objected to the legality of the variable levy under GATT), European agricultural policy has been by far the largest source of GATT complaints and section 301 actions brought by the United States against Europe.

Dating to the late 1950s, officially the CAP aims to achieve “stable and fair prices, a decent living for farmers, and an increase in agricultural productivity.”\footnote{This description of the CAP is based on} In addition, the program was founded on a principled preference for E.U. product in E.U. markets. The CAP attempts to accomplish these goals through a system based around price supports (including variable import levies to prevent imported commodities from being sold below the internally set prices),\footnote{These encompass three main mechanisms: target price, intervention price, and export subsidy. The target price is what the E.U. farmer would ideally get for her crops, including transportation costs. The intervention price is an annually adjusted figure at which the farmer can sell crops to public authorities; direct payments to farmers, and supply...
control. Naturally, the way these mechanisms are used varies from product to product, creating an extraordinarily complicated system. In general, the early CAP relied mostly on a minimum price guarantee enforced by variable import levies and unlimited intervention purchasing. Variable export subsidies and production controls were used when they were needed. Over time, a series of reforms has begun to reduce the support prices on some commodities (in lieu of increased direct payments) and control supply more directly by paying farmers to set aside land.

The ultimate result of the CAP was to shift the European Union from a net importer of most major agricultural commodities to a net exporter. As might be expected, the CAP resulted in periodic surpluses as production boomed and prices remained relatively constant. High prices also meant that downstream producers—namely canners and food processors—faced input costs that made them uncompetitive on world markets. Several long-standing disputes between the United States and the European Union emerged as the Union attempted to support such producers while keeping the CAP intact. In addition, E.U. export subsidies were needed to sell surpluses on world markets; the heavy subsidization quickly became another long-standing source of discontent. Low commodity prices in the 1980s exacerbated the tensions underlying the CAP.

A. Intransigence under GATT

The European Union has traditionally been non-compliant in disputes about agricultural policy, whether facing the United States or another country. Under GATT, between 1960 and 1994, fifty of the fifty-seven complaints against the E.U. (88 percent) were over agriculture. Of the seven complaints against non-agricultural practices, the E.U. offered concessions in six (86 percent). Of the fifty complaints against agriculture, concessions were offered in only nineteen cases (38 percent). In contrast, the concession rate for agriculture and non-agriculture sectors were comparable for non-E.U. signatories (approximately 74 percent). Following are some of the most stubborn disputes between the United States and the European Union under GATT:

Processed Food

The 1960s saw the first round of U.S. actions against E.U. agricultural policy under GATT. One example was the (in)famous “Chicken War.” There, the United States complained after inadequate E.U. compensation for the withdrawal of certain agricultural tariff bindings resulted in unilateral U.S. retaliation of $44 million. This measure was the thus a direct response to the formation of the Common Market. The

such crops usually go to E.U. storage locations. The export subsidy is paid to the farmer when world price falls below E.U. internal price—the payment enables the farmer to sell competitively. In the instances where world price actually exceeds the internal price, an export tax is imposed. Under the most recent CAP reforms, some commodities (particularly grains and beef) are being weaned away from the price control system in favor of direct payments.

162 (Hudec, Robert E. 1988; Bayard, Thomas O and Elliot, Kimberly Ann 1994)
163 See (Davis, Christina 2001). Of course, these numbers change depending on what the definition of a GATT dispute is. Unlike the WTO, disputes in GATT did not necessarily result in formal consultations or the formation of a panel. For example, the spat over steel in the early 1980s could be considered a “dispute” under GATT, even though a panel was never formed.
164 See (Conybeare, John A. C. 1987)
Union requested a Panel to determine whether the level of retaliation was appropriate; it was lowered to $26 million. The United States also complained about the CAP in two 1962 actions against France and Italy centered on processed food. The case with Italy was settled, but a GATT Panel was formed and decided against the France. Retaliation was averted after France promised concessions. In 1972, the United States revived the complaint against France, and formally requested that GATT endorse retaliation. France again prevented action by promising to comply, thereby rendering a GATT panel irrelevant.

The United States challenged temporary measures on imported tomato products in 1976. Removal of the offending practice again made any formal determination moot. However, the United States pursued the matter in a GATT panel in an attempt to deter future temporary actions by the Union; the United States won the case. Despite this defeat, the Union imposed new measures that achieved the same effect as the previous restrictions. That policy was a broader subsidy scheme that became the subject of a 1982 complaint by the United States over canned fruit. A GATT Panel found against the European Union, but the Union blocked the adoption of the Panel report. Retaliation was threatened, and a negotiated agreement was reached in December 1985. However, the Union violated the agreement in 1988, and another agreement in 1989 was needed to avoid U.S. retaliation.

**Oilseeds**

Accompanying the 1976 U.S. complaint against E.U. tomato products was another case concerning feed/dairy products. The temporary regulation in that case simultaneously relieved a surplus of dairy products in the Union while protecting producers of soybeans and the like. As with the other case, the United States, hoping to prevent future temporary actions by the Union, initiated a GATT Panel despite E.U. steps to remove the offending measure. The United States again won, but the European Union again imposed a new policy that achieved the same effect. The new practice on feed (which involved soybeans again) became the subject of a lengthy dispute over oilseeds.

In 1988, responding to the concerns of domestic oilseeds producers about the level of E.U. subsidies, the United States initiated a section 301 action and requested a GATT panel. The following year the Panel determined that the E.U. practice was in violation of E.U. obligations; the Union agreed to adopt the Panel’s decision within the negotiated agreement then pending in the Uruguay Round. When the Round failed to conclude on time, the Union implemented a new measure that was unsatisfactory to the United States.

In 1992, a Panel again heard the case, and again found the E.U. measure inconsistent with E.U. obligations. When the E.U. rejected the report, claiming it had already changed the offending measure, the United States threatened a $1 billion retaliation. When negotiations for compensation broke down, the United States requested GATT authorization to suspend concessions of $1 billion. The Union blocked the action. Consequently, the United States announced its intention to impose prohibitive tariffs on

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165 A dispute over chicken occurred again in 1980, when the United States complained about a poultry processing regulation in the United Kingdom that it believed violated E.U. obligations. However, U.S. exporters quickly adjusted and the United States withdrew the complaint when industry pressure subsequently diminished.
$300 million of E.U. imports. This retaliation was averted by an agreement that limited the amount of land that could enjoy E.U. subsidization. Despite pressure from France, the oilseeds agreement largely made it through the convoluted negotiations over agriculture that marked the final years of the Uruguay Round.

1981-82 GATT Cases

The 1982 GATT Panel on canned fruit was part of a legal barrage by the United States. In 1981-82, in addition to the canned fruit complaint, five actions were begun against E.U. agricultural policy; three proceeded to GATT Panel decisions that were blocked. The United States stopped adoption of a no-decision ruling on wheat flour subsidies. Panels ruled against the Union on pasta subsidies and preferential tariffs for Mediterranean citrus products. The Union blocked adoption of both reports.

The United States unilaterally retaliated in the citrus case against E.U. pasta exports; and the Union counter-retaliated. A negotiated settlement put an end to the dispute in August 1986. In a manner of speaking, the United States also retaliated in wheat flour – it subsidized U.S. industry enough to allow it to supply the entire Egyptian market for a year. The Union, after calling for a GATT panel on the U.S. subsidy, voluntarily restricted its wheat flour exports. In September 1987, a negotiated settlement ended the flour dispute as well.

B. Intransigence under Section 301

Many of the GATT actions in the 1970s and 1980s began as section 301 actions; the United States also used section 301 in several instances where GATT was not used. For example, section 301 had been used to pressure the Union on wheat flour since 1975. The two GATT complaints of 1976 were the product of the section 301 process, as were several of the 1981-82 flurry.

The pattern of E.U. intransigence is present in non-GATT section 301 cases as well – “concessions” were ineffective or replaced with new practices in cases concerning E.U. regulation of egg albumin, malt, and added sugar to canned fruit (the new measure on canned fruit, like the one on tomato products, was the subject of the GATT case of the early 1980s). The United States also refused to resort to GATT in 1986 when the Union implemented quotas on soybean and soybean oil as part of Spain and Portugal’s accession to the Union. Considering the GATT process to be too cumbersome, the United States threatened retaliation. After responding with its own threats, the Union finally agreed to concessions of $400 million over four years. The limited timeframe of the concessions has necessitated renegotiation more than once.

C. Intransigence under the WTO

Further U.S. action against certain CAP subsidies has been avoided because of the Uruguay Round’s extension of the “peace clause”, an agreement not to use the WTO

166 This was the same matter that was the subject of an informal complaint about E.U. tariff preferences for Mediterranean citrus products in the 1970s. The matter never reached a GATT Panel and was “settled” in 1973.
167 (Bayard, Thomas O and Elliot, Kimberly Ann 1994)
168 See (United States, Trade Representative 1996) and similar reports for subsequent years. Also (Cadot, Olivier and Webber, Douglas 2001) and (Rosegrant, Susan 1999)
subsidies code against a set of agricultural policies. The peace clause is set to expire at the end of 2003. However, this has not prevented the United States from challenging other E.U. agriculture practices in the WTO.

The most acrimonious dispute between the United States and the Union has been a U.S. complaint against the E.U. preferential trading regime that favored bananas from former colonial states. After section 301 actions in 1994 and 1995, the United States requested a WTO Panel in 1996. After adverse rulings by both a WTO Panel and the Appellate Body, the European Union enacted a new preferential regime that it claimed complied with its WTO obligations. The United States demurred, and the WTO agreed. In April 1999, a WTO arbitration authorized the United States to suspend concessions valued at $191.4 million annually. Retaliation continued until July 2001, when a bilateral agreement resulted in the retraction of the suspension action before the commencement of the Doha Round. While the bananas dispute did not directly implicate E.U. producers, the lengths to which the Union avoided compliance presage a similar experience should the United States use the WTO to challenge CAP provisions as it did under GATT and section 301.

A few additional disputes percolated in the 1990s. Retaliatory action was again averted in 1995, when the USTR challenged certain tariff increases (including agricultural products) surrounding the accession of Austria, Finland, and Sweden to the European Union. The section 301 action was terminated when a negotiated agreement resulted in the compensation of the United States to the satisfaction of the USTR. In 1997, the United States also requested consultations with the European Union about export subsidies on processed cheese.

D. Agriculture in Sum

While the early years of the CAP (the 1960s) were relatively quiet, the 1970s and 1980s revealed just how deep sentiments about the CAP ran. There are many reasons for E.U. intransigence on agriculture, but the end result is always the same: the CAP is a beast of extraordinary inertia.

II. Health Standards

E.U. restrictions on hormone-treated beef imports attracted much attention after complaints by the United States and Canada proceeded to retaliation. WTO arbitration authorized the United States to retaliate on over $100 million worth of imports from the European Union. While fought on the battleground of the role of health and safety standards in trade, the dispute over beef also holds strong threads of the contests over European agriculture described above.

The dispute over beef actually dates to December 1985, when the European Union first announced that it would ban the sale of beef from hormone-treated cattle. The Union admitted that it was responding to consumer pressure, not scientific evidence, but claimed that a ban did not violate GATT provisions because domestic and imported beef were treated identically. The United States initiated a section 301 action in

169 For a political analysis of US-EU frictions see (Grieco, Joseph 1990). For an analysis of EU failures to comply with the WTO rules see (Davis, Christina 2001).

170 See (Bayard, Thomas O and Elliot, Kimberly Ann 1994) and (Deveraux, Charan 2001) for more detailed accounts.
November 1987 and threatened retaliation if the beef restriction was adopted, arguing that without scientific evidence the ban amounted to an illegal trade restriction in the guise of a health standard. When the Union claimed it would counter-retaliate against several U.S. agricultural products, the United States then postured that it would block all imports of E.U. beef. The U.S. position was rooted in reciprocal meat inspection stipulations of the 1988 Trade Act and encompassed some $450 million of Union beef products.

The Union finally implemented the ban on 1 January 1989. The United States immediately retaliated against $100 million of E.U. exports. The European Union delayed counter-retaliation and a few small adjustments were made to improve trade relations. The level of retaliation was reduced somewhat when some U.S. producers began exporting hormone-free beef and the Union exempted pet food from the ban. Neither the United States nor the Union allowed GATT to mediate. The United States blocked the E.U. request for a Panel to rule on the legality of U.S. retaliation. The Union stopped a U.S. move for a technical experts group to determine the legitimacy of the E.U. ban under the GATT standards code.

Outside of the minor concessions on pet food and certifying certain U.S. exports as hormone-free, the dispute and accompanying retaliatory measures dragged on until June 1996, when the Union formally requested a WTO Panel to decide the matter. The United States terminated its retaliation the following month, pending the Panel’s ruling. Following adverse rulings by the Panel and the Appellate Body, the European Union subsequently failed to bring their law into compliance satisfactory to the WTO agreements. In July 1999, the United States received authorization from a WTO arbitration to suspend concessions of $116.8 million per year.

To date, the European Union has not complied with the WTO recommendations and the United States continues to suspend concessions. Like agriculture, E.U. acquiescence on beef and the larger question of health standards are constrained by domestic politics in the Union. The power of European consumer groups suggests that the Union will not be changing its standards on hormone-treated beef in the near future. Moreover, they anticipate many potential disputes about the health effects of genetically modified food in particular and biotechnology in general.

### III. Steel

After an initial set of voluntary restraint agreements on European steel exports to the United States in 1969-74, the continuing decline of both E.U. and U.S. steel industries in the 1970s created new pressures on trade relations. While a 1976 section 301 petition against an export agreement between Japan and the Union was aborted, two major

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171 Another dispute, on E.U. safety standards for meatpacking, never reached a GATT or WTO Panel; it began in 1987 and was pursued via section 301. While the United States requested the establishment of a GATT Panel, the Union blocked the request for a time sufficient for a settlement to make any GATT decision irrelevant. U.S. pork producers reopened the case in 1990, but the United States initially delayed bringing it before a GATT Panel. When the United States finally requested a Panel, the Union blocked the request again. Instead, another settlement was negotiated in 1992 that purported to resolve the differences between U.S. and E.U. meat inspection requirements.

172 For further analysis see (Hudec, Robert E. 1988) (Bayard, Thomas O and Elliot, Kimberly Ann 1994) (Lindsey, Brink, Grisworld, Daniel T. et al. 1999) (Hufbauer, Gary C. and Goodrich, Ben 2003) and the USTR web site USTR.gov.
disputes developed in the early 1980s. First, in 1982, U.S. integrated steel producers petitioned the Department of Commerce to investigate numerous E.U. manufacturers for dumping violations or subsidization. Several Union steel companies (particularly in Belgium, France, and Italy) were found to be significantly subsidized, and countervailing duties were threatened by the United States. Instead, in the same year the Commerce investigation commenced, a voluntary export restraint was established for the Union as a whole and unilateral U.S. action averted. Second, also in 1982, complaints by U.S. specialty steel manufacturers under section 301 against six European countries were converted to a section 201 investigation. Injury was found in May 1983 and relief through tariffs and quotas was granted in July. Negotiations for compensation failed, and the European Union retaliated against $160 million of U.S. exports. Another voluntary export restraint was negotiated in 1984, ending E.U. retaliation. In both cases, consultations were held under GATT subsidies provisions, but no Panels were formed and no decisions rendered. In 1985, under threat of a second 201 investigation for carbon steel, the 1982 VERs were extended through September 1989. Another extension meant that the VERs on carbon steel ultimately didn’t expire until March 1992.

Antidumping and countervailing duty cases dominated the 1990s, with relations between Europe and the United States further soured when negotiations for the Multilateral Steel Agreement broke down. In 2001, the Bush administration, responding to complaints from both integrated producers and mini-mills, initiated a section 201 investigation that found injury in several major steel product categories. Relief was ordered through substantial tariffs in March 2002. While attempting to negotiate satisfactory exceptions to the 201 order with the United States, the European Union requested a WTO Panel in May 2002. The Union claims damages of over $2 billion, and several rounds of exemptions have been negotiated.

Like the European Union’s policies on agriculture and health standards, the United States faces domestic political concerns that encourage it to move to the fringes of its WTO obligations on steel. While safeguard actions are considerably less flagrant than defiance on the CAP or beef, they are a result of the same intransigence. As long as the U.S. steel lobby remains powerful, the United States will have incentives to find dubious room in the WTO agreements to grant the industry relief. The European Union, having gone through a painful domestic restructuring and denied the negotiated alternative of the VER, is not likely to indulge U.S. actions under the WTO’s dispute settlement mechanism.

IV. Tax Policy  

The E.U. complaint to the WTO about the U.S. Foreign Sales Corporation (FSC) is the largest trade dispute threatening economic relations across the Atlantic. After an adverse ruling by the Appellate Body, the United States changed the FSC legislation in an attempt to comply with the WTO ruling. However, the new provisions were also found illegal, and now the United States faces an estimated $4 billion retaliation by the European Union if it fails to meet its obligations again.

The predecessor of FSC was the Domestic International Sales Corporation (DISC). In 1973, the European Union filed its first-ever complaint under GATT, alleging that the DISC was an illegal subsidy to U.S. exporters. In response, the United States

173 See (Hufbauer, Gary C. 2002) and (Hudec, Robert E. 1988)
filed three GATT claims against Belgium, France, and the Netherlands, claiming that the territoriality feature of their income tax systems allowed some export income to avoid taxation in the same way in the same manner the DISC worked. The United States demanded that all four cases be linked together in front of a single GATT Panel. While the Panel eventually ruled in 1976 that all four defendants were guilty, the U.S. policy was still considered by many countries to be the only truly illegal practice. Neither the European defendants nor the United States allowed the ruling against it to be adopted. While the DISC constituted an obvious subsidy, many GATT countries (including, arguably, the United States before the 1960s) used territorial income tax provisions to reduce taxes on exports.

In 1981, both the United States and the European Union agreed to the adoption of both panel reports as qualified by an Understanding adopted by the GATT Council. A key finding of that understanding was that countries were not obligated to tax export income that came from “economic processes occurring outside their territorial limits.” Under the Understanding, the European territorial tax systems would be considered in compliance with the GATT agreements. While the United States claimed that the DISC was similarly compliant, the Union and other GATT signatories threatened sanctions if the United States did not change its tax regime. In 1984, without conceding that the DISC was non-compliant, the United States replaced the DISC with the FSC. The FSC was tailoring almost explicitly to fit the terms of the 1981 Understanding that had been adopted by the GATT Council.

Fourteen years later, in 1998, the European Union requested the WTO establish a Panel to rule on whether or not FSC constituted an illegal export subsidy under the SCM agreement that went into force in January 1995. The United States defended the FSC by explaining that it had been modeled on the 1981 GATT Understanding. The EU denied that the Understanding had been carried forward from the GATT into the WTO and even questioned whether the Understanding was binding in 1981 at the time that it was enacted. After adverse Panel and Appellate Body rulings, the United States attempted compliance with Extraterritorial Income (ETI) legislation. Even before its enactment, ETI was condemned by the Union as non-compliant. In August 2001, a WTO Panel again ruled against the United States; the Appellate Body affirmed. The Union then sought and received authorization from WTO arbitration to suspend concessions of $4 billion. However, the Union has indicated it will wait some time before retaliating.

Unlike the previous three examples, U.S. tax policy is marked more by foot-dragging than intransigence. The United State clearly wants to make sure its corporate tax code is competitive with Europe’s. However, unlike commodities like steel or agriculture, there are many ways by which that goal can be achieved. While the United States has been far from eager to revise its code -- the ETI legislation passed in 2000 was essentially a delaying tactic -- those responsible for tax policy in the congress and the administration have indicated a willingness to comply.

Despite such efforts, U.S. intransigence is apparent in that it refuses to abandon the policy completely. The European Union has seized on this position, leaving some to think that Europe’s complaints against the DISC and the FSC have another role in transatlantic trade disputes, as a hammer against the perceived excesses of U.S. trade legalism. Before the DISC complaint, the Union largely considered GATT a diplomatic endeavor. U.S. action under GATT Panels was met with rhetoric arguing against the
legalization of international trade. Therefore, the DISC suit was thought by many to be
the whip the Union hoped would reign in the U.S. legal zeal. Similarly, the WTO
complaint against FSC was seen as a response to the beef and banana cases, unilateral
U.S. action preceding a WTO arbitral proceeding, and especially the enactment of
“carousel” penalties. Neither the DISC nor the FSC cases have dampened the legal zeal
of the United States.

V. Conclusions

Imperfect practice and the only game in town: the long and torrid history of the
US-EU trading relationship has showcased the first and tested the second. Imperfect
practice has remained, no matter what the trade rules of the day are. Such practice has
occurred in an environment of intransigence, with both sides refusing to comply with
WTO rules on key issues. It’s clear that domestic political considerations have forced
both the European Union and the United States to defect from established international
trade obligations both before and after the WTO.

If history is any indication, there are reasons for concern. As the practice and
inertia of transatlantic trade disputes have remained, the world has changed dramatically.
Prior to 1994, there were several paths to resolution, and certainly no Dispute Settlement
Body. Practice is still imperfect, but now only one game – one system – is available.
Can one system handle such an environment of intransigence?

In the past, problems with the CAP were controlled largely by negotiated
agreements brought about because the United States couldn’t force the adoption of a
GATT Panel ruling. Now, many of the same problems remain, but the United States can
resort to a dispute mechanism that either forces the Union to comply/compensate or
authorizes the United States to retaliate. This system lodges the European Union between
the rock of domestic politics and the hard place of WTO dispute settlement. Since the
historical analysis reveals a clear preference for domestic politics, might not the Union be
facing enormous retaliation?

Export subsidies under the CAP are the largest source of worry. According to
official notifications to the WTO, the European Union spent, on average, $6 billion a year
subsidizing agricultural exports from 1995 to 1998. When the peace clause expires in
2003, many of those subsidies could become fair game under the WTO’s Agreement on
Subsidies and Countervailing Measures. Given its demonstrated historical commitment
to reigning in the CAP, the United States can be expected to pursue at least some cases in
the WTO. The E.U.’s unrelenting case against U.S. Foreign Sales Corporations can only
serve to spur such action.

Similar patterns emerge in other areas. The European Union has steadfastly
refused to revise its policy on hormone-treated beef, indicating that additional retaliation
may be invoked should the Union listen to consumer interests on other issues. Disputes
over U.S. steel policy used to be channeled through VERs; now such measures are illegal
under the WTO. E.U. complaints about U.S. steel protection must also be funneled
through the DSB. The results could be grievous: the most recent safeguard action is
being met with threats of massive retaliation. Furthermore, U.S. pressure on E.U.
agricultural policy (bananas) and health standard (beef) has induced the protracted debate

174 See also (Pettersman, Ernsit-Ulrich 2000)
over FSC. Would the European Union have pursued the FSC (after letting the sleeping dog lie for 14 years) had it not faced the pain imposed by the WTO?

It very well could be that the WTO is robust enough, and the U.S.-E.U. relationship strong enough, that all this acrimony and history can indeed be handled by one system. However, the WTO would have a better chance of succeeding if the practice of both the United States and the European Union in dispute settlement were improved. There have been far too many instances of violations; in the case of the EU, in agriculture and food, and in the case of the US in administered protection. Like charity, compliance begins (and ends) at home. Both the US and the EU should acknowledge that they have serious compliance problems and take steps to improve this performance, perhaps through establishing systems for internal reviews of the WTO-consistency of measures in these key areas.

When ratification of the Uruguay Round Agreement was being debated in 1994, Senator Robert Dole proposed a “WTO Dispute Settlement Review Commission”. Comprising five Federal appellate judges, this commission was to review all final dispute settlement reports adverse to the United States. If the Commission found, within any five year period, three decisions in which a WTO panel “demonstrably exceeded its authority” or “acted arbitrarily or capriciously” then any member of congress could force vote on a joint resolution mandating US withdrawal from the WTO. The need for a similar commission to examine domestic actions, is surely no less great.

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175 This draws on (Destler, I.M 1995) page 253.
Chapter 5
Options for change.

Previous chapters outlined the principal features of the WTO system, and considered how it has operated in practice. This chapter considers some ideas for reform. After reviewing the strengths and weaknesses of several reform proposals in the literature, it proposes a novel system based on pre-negotiated contingent liberalization commitments (CLCs). Members providing CLCs would eliminate the ability of other Members to suspend concessions in response to violations. Such a system could provide additional incentives for compliance; an effective opt-out mechanism; and enhance parity for smaller participants. Moreover, it would achieve these improvements while respecting national sovereignty and preserving the essential WTO principle of reciprocity.

Eliminate re-balancing. Many international institutions and treaties obtain compliance from their Members by relying on the force of international public opinion and the desire of countries to maintain their reputations as abiding by their international commitments. Why not eliminate the WTO provisions that allow compensation and the suspension of concessions and establish a system based simply on binding international commitments? Such a system would have several advantages: Indeed, it would mitigate three of the four problems that have been identified. The WTO would not be in business of approving protection. Members would not be subject to trade retaliation or penalties -- they would comply with WTO agreements in the same way as they comply with other binding international treaties. Large and small Members would be treated equally. For some, another virtue of this option is that the WTO enforcement system would no longer be unique. This would remove the incentive to use the WTO to enforce rules, such as intellectual property, that arguably do not belong in a trade agreement but are put there by powerful interests eager to use the WTO enforcement mechanism to further their goals.

But this proposal would weaken the incentives for compliance. To be sure, for the most part, countries do not comply with WTO rules because of retaliation. Nonetheless, retaliation can play an important role in mitigating the inducements countries may face to violate WTO agreements. Large countries can improve their terms of trade if they raise their trade barriers and others do not retaliate. Thus a system in which some violate the rules, while others are constrained by the rules not to respond, can, by reducing the probability of retaliation, lead to less liberalization. Eliminating the trade responses to violations would also fundamentally change the nature of the system by removing the mechanism for maintaining reciprocity. The political and economic advantages described in greater depth in chapter two would be lost.

The threat of retaliation can also assist governments in enhancing policy credibility. There could be a time consistency problem if private actors must commit resources before the government puts all its policies in place. For example, an investor may be wary of developing an oilfield if she suspects the government could then nationalize it. By signing enforceable trade agreements with consequences for violations,

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176The case for such international systems is made in (Chayes, Abram and Chayes, Antonia 1995)
governments can lock-in their commitments to policies that can provide assurance to private actors making long-lived resource allocation decisions. It is difficult for governments to implement policies that create losers even when in the aggregate these bring benefits. International commitments with consequences for exporters can also help governments resist protectionist pressures. In particular, if domestic export interests fear they may be denied access to foreign markets in the event of noncompliance, they will serve as a counterweight to interests in import-competing sectors.

**Allow Only Compensatory Liberalization.** Many free traders object to an organization whose purpose is to achieve freer trade actually allowing barriers to be resurrected. The Meltzer Commission to the US Congress, for example, complained about allowing claimants “to shoot themselves in the foot” by adding the insult of higher domestic tariffs to the injury of a foreign violation. Some in this camp, therefore, advocate confining the options available to a violating defendant to providing alternative concessions. (Some would also give it the alternative of paying a monetary fine, to be discussed below).

The attraction of this proposal is that it would avoid additional protection. It would also create incentives for groups desiring trade protection to encourage compliance to avoid having liberalization of their sectors become part of the compensation. It would also help to rectify the imbalance in the current system that favors large countries with market power.

However, this solution requires cooperation from the defendant. The virtue of suspension is that it is something the plaintiff can undertake unilaterally. This alternative system could be thwarted by the difficulties of negotiating compensation that both sides could agree on. Giving the defendant in a case *carte blanche* to select the products for liberalization would lead to strategic gamesmanship that might limit the value of concessions. A suggestion that would deal with this problem is Paulwyn’s proposal to allow the complaining party to choose the tariffs that it would receive as compensation. However this would undoubtedly be politically objectionable since it would entail countries giving up the right to set their own trade barriers. This would surely represent an unwarranted intrusion into national sovereignty and it is extremely unlikely that WTO Members would accept it.

**Enhance Penalties.** Taken at face value, the current system of rebalancing concessions may not offer sufficient inducement for compliance. Generally, in most penal codes, violations must be met by punishment. “If, at worst, violating the WTO can lead to countermeasures that are no greater than the violation,” critics ask, “how do these measures achieve compliance?” Trade legal scholar Petros C. Mavroidis, voices such concerns and therefore criticizes the current system on effectiveness grounds. Mavroidis also points to the system’s failure to enforce compliance by the European Union in the Beef-Hormones case as proof that penalties are insufficiently strong. Moreover, since it makes no provision for retroactive compensation, the system may actually provide countries with incentives to commit temporary violations. For example,

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177 See (Staiger, Robert 1995) section 3.2 for a summary of this literature.

178 cited by (Horlick, Gary N.)

179 (Mavroidis, Petros C. 2000)
it will probably take the DSB about eighteen months to determine whether the United States acted illegally in applying safeguard measures to protect the steel industry in 2002. Even if the Bush Administration then responds by eliminating these measures, it would have derived (some political) benefits from having applied them.

Strengthening the punitive impact of the system could also make it clear that WTO obligations are binding under international law. According to Joost Pauwelyn, increasingly WTO obligations entail acceptance of rules. “Whereas a balancing act may be acceptable to governments, legal rules affecting individuals call for greater predictability and stability. Such rules need to be respected as international obligations, not as some political promise that can be withdrawn or exchanged for another.”[180] He mentions TRIPs and SPS as examples in which the idea of bilateral balancing of concessions is less relevant.

Why not then implement a tougher system in which violators could face suspensions of concessions that were double or even triple the violations for some period of time? Fines could also be used to compensate plaintiffs for harm done by the violation prior to the adoption of the ruling.

A more punitive system would provide greater incentives for compliance with existing agreements but it would also have numerous disadvantages. Let us consider stronger retaliatory penalties before considering fines.

First, tougher penalties could lead to less liberalization in the future. The ability to opt out on occasion may actually re-enforce rather than weaken the system by serving as a safety-valve. In making concessions and signing agreements in the first place, countries have to consider the risk that, perhaps for reasons beyond their control, they might subsequently be found to violate its provisions. Indeed, when agreements are ambiguous and unclear, as many provisions of trade agreements inevitably are, countries may genuinely be surprised to learn (the hard way) what an agreement really means. If they are then required to provide compensation (or face higher foreign tariffs of much higher magnitude) they might prefer not to take the risk of agreeing in the first place. The current system provides countries with the assurance that they cannot be made worse off by signing an agreement, since it allows them to revert to the status quo ante in the event others breach the agreement. In a system with trade penalties, this assurance would no longer be present.

Reciprocity would be disturbed and all the advantages associated with a system based on reciprocity would be lost. In particular, recall that Wilfred Ethier’s work demonstrates that an optimal amount of liberalization will occur in a system based on commensurate rebalancing when ex ante they are unsure whether they might have to resort to violations in future.

Second, tougher penalties could build in the danger of an escalating trade war. The WTO provides a framework for its Members to engage in a repeated game that seeks to enhance their cooperation to achieve free trade and the rule of law. Part of that game entails negotiating agreements and part involves ensuring that these are implemented. As currently designed the system ensures that defections are met with no more than a tit-for-tat response, a strategy that is seen often to produce successful cooperation and mutual benefits in repeated games. By contrast a system based on penalties could result in each

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[180] (Pauwelyn, Joost 2000)
Third, the result of stronger retaliatory penalties could simply be more protection. It is by no means certain that countries will be very sensitive to variations in sanctions. Countries generally fail to comply, despite the potential damage to their reputations, when there are very strong political obstacles. Under these circumstances there is the danger that even if suspensions were to be made punitive, these countries may still find it difficult to comply. The net result of such a system could be to increase the amount of trade protection. Moreover, at some point, sufficiently high penalties could drive countries out of the WTO.

Fourth, countries may actually be less willing to apply large penalties than simply to rebalance concessions. Thus instead of adding to deterrence tougher penalties could be less credible. Raising tariff barriers can be costly to the plaintiff nation. In an interdependent global economy, import distributors, and firms and consumers dependent on imports will all resist retaliation in the first place. Indeed, the dollar values associated with the FSC/ETI case are so large that many in the United States have argued that it would be too disruptive for the EU to retaliate. 181

Fifth, penalties would surely provide more ammunition for those who believe the WTO undermines national sovereignty. The combination of a veto-proof dispute settlement system and punitive retaliatory responses would then really entail a system in which national governments could find themselves subject to trade sanctions in the face of DSB rulings with which they did not agree. Proportionality between violations and responses helps maintain the legitimacy of the current system.

Sixth, tougher trade penalties would enhance the system’s asymmetries. Adding penalties would increase the advantage enjoyed by countries that can credibly threaten to retaliate and leave those unable to retaliate feeling even more like second-class Members.

Finally, in addition to stronger penalties, some mention the possibility of providing for reparations. WTO remedies are prospective. Countries that commit infractions but then come into compliance suffer no consequences. Since there are delays in the Dispute Settlement process, this may create incentives and opportunities for non-compliance. Reparations might indeed lead to more compliance, but would also have most of the disadvantages associated with penalties. In addition, the current system assumes that Members, as sovereign countries, act in good faith. And indeed there are cases of genuine disagreement over the meaning of WTO rules. The DSB should not be placed in the position of having to assess whether countries have deliberately or inadvertently violated an agreement. Again, as an agreement among sovereign countries the WTO is probably better off not being involved in judgments about whether countries intended to violate or did so accidentally.

181 Even large countries will be unwilling to retaliate beyond levels associated with rebalancing concessions. Assume countries start with a non-cooperative Nash equilibrium; each sets its tariffs at optimal levels, given the levels in the other. Assume they negotiate a reciprocal reduction in tariffs. Now assume one reverts back to the initial level, thereby reneging on the agreement. The most the other would like to raise its tariff is also back to original level. While it would improve its welfare by rebalancing, moving to raise tariffs even higher would reduce its welfare, since such levels would exceed its optimal tariff.
**Fines.** Responding to violations by requiring the payment of monetary fines would deal with some of the problems that have been raised with the current DSU. Fines have the virtue of avoiding additional trade protection. A system based on fines would not place smaller countries at a disadvantage. Indeed these were advocated in the Uruguay-Brazil plan for dealing with GATT Article XXIII procedures in the 1960s. Fines would also allow for more efficient compensation. Restoring reciprocity through trade retaliation is an imprecise mechanism. It creates collateral damage by harming those who purchase imports and it fail to directly compensate exporters. By contrast, monetary compensation avoids the damage to importers and if redistributed directly to exporters, would allow plaintiff governments directly to compensate the parties actually hurt by the violation.

Such a system could bring the WTO more closely in line with a traditional contract system. Monetary compensation could, in principle, meet three objectives simultaneously. First, the system would provide incentives for compliance; second, it would provide compensation to defendants regardless of their size – thereby correcting the current asymmetry between large and small countries; and third, unlike retaliation it could permit efficient contract breach. By requiring the payment of damages that would make the plaintiff as well off as it would have been had the agreement been fulfilled – so called “expectation” damages – the mechanism would lead to breach only when the violator was made better off and the plaintiff no worse off. Under these circumstances, payment of fines would act as a safety valve and escape mechanism.

There are however problems with such a system. The first is deciding how to place a monetary value on violations. This is a problem with which lawyers have considerable experience since the task of attaching monetary values owed to injured parties due to unlawful activity is commonly tackled in civil liability proceedings in domestic law.

One approach would be to establish a punitive system with fines set at a fixed percentage of the value of trade involved. This approach has the advantage of being simple to implement, but it would not be a simple matter to actually set fines at the correct level. If they were set too high, the system could discourage the signing of new agreements; if they were set too low, it might reduce incentives for compliance.

A second approach would be to try to establish a system that avoided punitive or arbitrary measures and tried to estimate the monetary equivalence of trade obligations in order to implement the notion of expectation damages. This would be more in keeping with the current system in which the countermeasures adopted in response to violations are equivalent to the value of trade involved. But how much, for example, should the United States be paid when its exporters are denied the ability to sell their hormone-fed beef in Europe? In principle, the answer is surely not the full value of the beef exports. The correct figure should reflect the impact of the incomes of beef producers between selling their beef to Europe and the next best available alternative. But obtaining this number is by no means straightforward. In principle, assuming the product is produced

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182 The ability to avoid protectionist responses through fines has led the United States to propose using fines from violations relating to rules regarding labor and environmental standards in bilateral free trade agreements.

183 See (Dam, Kenneth W. 1970) pp 368-373.
competitively it requires a complex econometric model that embodies estimates of supply and demand elasticities to provide the answer. A rather complicated calculation would be required – one that would certainly require study of the particular market involved.

To be sure, the alternative to a system in which liability is actually assessed, is a system that, absent compensation, requires the performance of contracts. In this arrangement the violator would be required either to suspend the violation or offer monetary compensation to the plaintiff. This type of system can also result in “efficient breaches” and is more attractive if it is costly to establish the value of liabilities.  

A second practical problem would be actually collecting the fines. The WTO system is ingenious because its enforcement system is based on trade, and thus rebalancing occurs within the system it controls. Resorting to fines, by contrast, would require measures taken outside the system. Fines could prove extremely difficult to collect, since in many countries (the United States for example) such payments would require specific budgetary authorization. The US congress has a long history, dating back to the 1800s of refusing to pass the funds to meet US international treaty obligations. The most notorious recent case is US failure to pay its dues to the United Nations.

This difficulty simply highlights another problem with a system of fines. The idea of accepting an obligation to allow foreigners to levy monetary penalties on the United States (or other nations) would undoubtedly be decried as taxation without representation, and the WTO would again be attacked for eroding national sovereignty.

The WTO system has rarely resulted in retaliation being implemented. To those who see the purpose of rebalancing concessions as a mechanism to induce compliance, this is a problem. But the system also has the merit of maintaining reciprocity. If nations chose not to retaliate, this could also indicate they do not believe they were harmed by their earlier “concessions”. But nations would be more willing to collect fines, even in cases where they had not been damaged by their earlier concessions. The use of fines would also disturb the maintenance of (trade) reciprocity. It would imply that compensation is no longer about maintaining trade reciprocity, and thus radically alter the fundamental basis of the system. Financial incentives, particularly if punitive, could increase the number of cases brought in a system that is already overburdened

Finally, as Charnovitz has noted, proponents of other international issues have looked upon the WTO with “sanctions envy.” There is a sense in which the use of trade as the metric for re-balancing concessions helps ensure that the WTO concentrates on trade-related issues. To be sure, as the scope of the WTO has expanded, establishing a trade-equivalence for the impact of violations has become increasingly difficult. Likewise the trade-equivalence of failures to enforce intellectual property protection is also difficult to estimate. In the case of subsidies, for example, the WTO has resorted to a pragmatic simplification – equating financial outlays for subsidies with a value of trade concessions. If the WTO became an international fine collector, however, there would be no limit to the issues that could be covered by its rules. A move in this direction would therefore subject the institution to even greater pressures to expand its mission.

In sum, while in principle a system based on fines would have some attractive properties, in practice, setting up such a system would not be easy. Even more problematic would be actually collecting the money.

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184 These systems are discussed in (Schwartz, Warren F. and Sykes, Alan O. 2002)
PreAuthorized Compensation: contingent liberalization commitments. Each of the options considered thus far has defects: eliminating re-balancing would reduce incentives for compliance; multilateral retaliation creates a system dependent on the willingness of Members to raise trade barriers; confining re-balancing to compensation depends on the willingness of defendants to provide compensation acceptable to the plaintiff; fines are hard to assess and difficult to collect. Punitive fines and retaliation could inhibit future agreements, disturb reciprocity and raise concerns about sovereignty. But there is another approach that would be more effective in dealing with the problems while preserving the essential character of the system— contingent liberalization commitments. (CLC’s)

In this approach, WTO Members would be given the option of offering a pre-authorizing compensation mechanism during the Doha Round negotiations. These deposit offers would be included in the multilateral negotiations. If a country’s offer is accepted, in event it is later found to have violated the agreement and failed to come into compliance, winning plaintiffs would be authorized to select an equivalent package of concessions from the defendant’s commitments. Countries could chose from several options in making their CLC offers. They could indicate a willingness to provide (selective) financial compensation, they could agree to provide across the board (MFN) tariff cuts to generate additional trade equal to the value of the infraction, or they could agree to liberalize certain sectors on an MFN basis. Since the sectors to be covered would be negotiated, in the multilateral setting, countries specialized in particular exports e.g. textiles could form alliances to ensure that products of interest to them would be included in the commitments of important trading partners.

This system would have numerous advantages. For defendant countries with CLCs, the WTO would no longer authorize retrogressive protectionist responses. Compliance incentives would be improved. Countries that are currently unable to effectively threaten retaliation would now have a viable mechanism to exercise their rights to compensation. By pre-announcement of sectors in which liberalization might take place, or of a willingness to pay compensation would create domestic constituencies in each country that would lobby for compliance, motivated by the prospects of losing protection, tariff revenue or of having to pay compensation. Unlike a system that simply required compensation with other tariff reductions, this system would not be subject to the difficulties of finding mutually acceptable concessions. This system respects national sovereignty. Unlike a system in which plaintiffs could order the defendant to liberalize particular sectors, this mechanism of pre-selection would not violate the capacity of potential defendants themselves to choose sectors for liberalization. Unlike a system based on fines, the remedy could be internal to the trading system and not require additional budgetary or legislative in defendant nations in which collecting such payments are a problem. Smaller countries would no longer be subject to inequitable treatment. They would be just as able to pursue their interests as their larger counterparts. The system would preserve the essential principles on which the WTO is based. Reciprocity would be maintained: The response to violations would still be a re-balancing of concessions and Members would have an acceptable “opt-out” mechanism.

There are other more complex considerations with the CLC approach. Industries named as part of a Member’s CLC could be adversely affected simply by the threat of having their protection removed. At the margin this could discourage investment and
other forms of expansion in these industries. This might not always be bad. Putting sectors on notice that more liberalization was possible could facilitate their long adjustment to free trade. In setting up their commitments, Members could minimize these effects by spreading the CLC’s across many sectors. This strategy would also limit the amount of political gamesmanship that could be played by plaintiffs in designing their retaliation -- a more general feature of the CLC system – and retain its relevance in the face of changing trade patterns.

Could countries always be sure that defendants’ CLC’s would contain sectors in which plaintiff exporters were competitive? Probably not. Although most developed countries do have exports in many sectors, some developing countries with highly concentrated exports might not always be able to benefit from exercising their CLC rights. Still, most would be able to, and compared to the current system, in which the ability to retaliate is simply not something most developing countries would resort to, the number of countries able to avail themselves of the system would surely be increased.

In addition, since the liberalization would occur on an MFN basis, plaintiff countries given the right to invoke concessions in a particular sector might use that right in a manner agreed with other Members, in return for those Members providing concessions of interest to the plaintiff. This would introduce, implicitly, an element of tradability into retaliation awards.

Developing countries (or perhaps the least developed countries) could also be given the option of requesting special duty free access for their exports up to a certain value. This system of tariff rate quotas would essentially enable them to obtain their compensation through quota rents, rather than increased market access.

There is a valid concern that the requirement of pre-designating CLCs could lead countries to be less willing to liberalize in the first place. This is certainly a possibility. But it needs to be weighed against the danger in current system that retaliation and counter-retaliation in cases that are not resolved could eventually lead to a substantial increase in protection. The more significant this problem becomes, the more attractive an CLC system will become. Indeed, although I have advocated CLCs on a voluntary basis they could also be made mandatory –thereby effectively eliminating retaliation through the suspension of concessions.

The problem of cumulative retaliations could be ameliorated in other ways. One would be netting out. Currently, the US has been authorized, and has retaliated against the EU in the beef hormones case to the value of $119 million. The EU has been authorized to retaliate in FSC by $4billion. In current system, both the US and EU could raise tariffs by the amount authorized. Instead, if the system applied netting out, the EU would simply be authorized to retaliate in the amount of $3.881 billion and the US required to remove its retaliation for EU Beef. While this approach is an alternative method of rebalancing and maintaining reciprocity, clearly it could encourage countries to bring cases with a view to buying protection against possible retaliation. Overtime, however, it might also weaken the pressures to comply.

A second method would be essentially to convert retaliation into compensation in the course of the next multilateral round of negotiations. Countries that have failed to come into compliance should be required to submit additional liberalization offers to those countries that have been authorized to retaliate. These offers would be used to
obtain waivers that would permit the slate of retaliations to be wiped clean once a new multilateral agreement was signed.
Chapter 6: Concluding Comments.

The introduction to this analysis raised four major concerns about WTO dispute settlement: It has led to more protection, it is ineffective in enforcing compliance, it has undermined national sovereignty (through sanctions and judicial activism) and it is unfair to smaller participants. Are these concerns warranted?

Protection. Retaliation in response to violations under the WTO remains rare. It has only been implemented by one large Member (the US) in two cases (beef and bananas) and is now threatened by another large Member (the EU in response to FSC-ETI.) In some cases, had the previous GATT system been in operation, with the possible exception of the FSC, similar measures would probably have been imposed unilaterally, without WTO authorization and oversight. Nonetheless, authorizations of the $4billion magnitude given to the EU in response to FSC-ETI are substantial and could seriously disrupt trade. They could also spur escalation. In addition, although they have so far decided not to exercise their rights, other countries (e.g. Ecuador, Canada and Brazil) have been authorized to suspend concessions. In addition, there is a real danger that in their rulings under the SCM agreement the arbitrators are becoming increasingly punitive. It would surely be preferable if the WTO could devise a mechanism that avoided retaliation while remaining as effective as the current system in providing incentives for compliance, a legal escape clause and maintaining reciprocity.

Compliance. Compliance with WTO and GATT rulings has generally been good although it not always been rapid. At times, (e.g. the US-FSC and EU in Bananas) countries have made superficial changes in their policies that have not actually brought them into compliance. Nonetheless, upon being found in violation, in every case, Members have announced their intention to comply and the preponderance of the cases have been settled. Why is compliance common if retaliation is rare? In some economic models of trade negotiations, compliance depends only on the probability and size of retaliation. But other factors are surely more important. First, there are often important parties within each country that have an interest in compliance: for example, consumers, exporters and import distributors. Second, even when there is disagreement over a particular case, Members come into compliance because they continue to believe that overall a trading system based on rules will on serve the nation’s interest. Third, officials and others value their reputations as rule-abiding participants because of the interests they have in the current agreement and their desire to be taken seriously when negotiating new agreements. Countries are aware that compliance on their part could influence the probably that other countries will comply in the future. They are aware that other Members are unlikely to grant politically painful concessions if they have little faith that a negotiating partner will meet its commitments and fourth, countries generally have ongoing relationships in other spheres. Countries that depend on the United States for aid and defense, for example, might be more willing to comply with findings of disputes in which it is involved.

However, it remains true that compliance is aided by the prospect of retaliation.

185 See (Hudec, Robert E. 2002) page 82.
Moreover, the system should itself not provide incentives for violations by preventing countries from re-balancing concessions in response to violations. Nonetheless, despite all the reasons for compliance, there will inevitably be cases, such as beef-hormones in which a Member has preferred to violate the agreement notwithstanding the impact of retaliation and the harm that may be done to its reputation and relationships. In these cases the system’s role is to prevent deadlock leading to escalation. In this respect the WTO has generally been successful, although there remain dangers in the current US-EU frictions.

_Sovereignty._ Sovereignty is a slippery concept that has been given a variety of meanings and connotations. As Stephen Krasner has argued, the invocation of the notion is often been associated with “organized hypocrisy.” One notion of sovereignty that does have a clear meaning is as a synonym for ultimate legal authority. Who has the right to make the rules? In this most meaningful sense, Members of the WTO do not yield their sovereignty. The U.S. Constitution places legislative authority with the US Congress and US laws cannot constitutionally be made elsewhere. The US Supreme Court has held, for example, that even if the Congress decides to delegate more power to the Executive branch, it may not do so without a change in the Constitution. When Congress gave the President the authority to veto individual line items in the budget for example, the Supreme Court declared this delegation unconstitutional. If the Congress cannot yield its authority to the President, it certainly cannot yield it to the WTO!

Article I of the Constitution gives the Congress the (exclusive) power “to lay and collect taxes, duties, imposts and excises” and “to regulate commerce with foreign nations and among the several states” and the Congress has shown absolutely no inclination to try to delegate this authority to someone else. Indeed it guards this power jealously. Even the US president cannot change US trade laws. While the President may negotiate trade agreements, if these involve changes in US law, he needs authority to do so from the Congress. Between 1934 and 1962, the Congress allowed the President to negotiate tariff and other concessions under the Reciprocal Trade Agreements Act. But it did so only for specified periods of one to three years at a time. Once trade agreements began to cover measures besides tariffs, Congress has made clear that if trade agreements would require a change US laws, this cannot happen without Congressional passage of the changes. Remarkably, perhaps, even after it has approved a trade agreement, the Congress can adopt laws that are in conflict with it. Under US law, international

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186 (Krasner, Stephen D. 2001)
187 Writing for the majority, Justice Stevens wrote: “The Line Item Veto Act authorizes the President himself to effect the repeal of laws, for his own policy reasons, without observing the procedures [*132] set out in Article I, 7. The fact that Congress intended such a result is of no moment. Although Congress presumably anticipated that the President might cancel some of the items in the Balanced Budget Act and in the Taxpayer Relief Act, Congress cannot alter the procedures set out in Article I, 7, without amending the Constitution.
188 Section 12 (c) If the President enters into a trade agreement which establishes rules or procedures, including those set forth in subsection (a), promoting the development of an open, nondiscriminatory, and fair world economic system and if the implementation of such agreement will change any provision of Federal law (including a material change in an administrative rule), such agreement shall take effect with respect to the United States only if the appropriate implementing legislation is enacted by the Congress unless implementation of such agreement is effected pursuant to authority delegated by Congress.”
189 (Boyers, James M. 1998)
treaties have the same authority as federal Law. This implies that the Congress can pass laws that violate US treaty obligations in precisely the same way as it can pass new laws that conflict with earlier laws. In particular, the Congress can legally pass trade measures that violate the WTO.\textsuperscript{190} Congress may thus later deny what it has previously given.\textsuperscript{191} As Patrick Low notes, “In practice, this means that the status of the GATT and associated agreements under U.S. laws gives virtually limitless potential in US trade policy for noncompliance with GATT.”\textsuperscript{192} In Europe, similarly, both legislatures and executives of the European Community assert domestic power to adopt "later-in-time-legislation" and domestic implementing measures inconsistent with their international WTO obligations. And, in both the U.S. and the European Union, legislation on the implementation of the WTO Agreement prevents private citizens from invoking WTO rules before domestic courts vis-a-vis domestic legislation that is inconsistent with WTO law.

Sovereignty has other meanings in addition to the idea of legal authority. One of these refers to the ultimate power, the practical (as opposed to the legal) ability of the state to control behavior. Some states have difficulties in exerting such control domestically – the phenomenon of failed states exemplifies this dimension. But states also have an interest in controlling behavior beyond their borders. One mechanism for such control is the treaty. Paradoxically, therefore, concluding treaties is an act of sovereignty. By agreeing to constrain its own behavior, the state constrains the behavior of others. The WTO is just such an agreement.

Some object that by signing a WTO agreement, a country restricts its ability to act autonomously and as such, entails a constraint on its freedom of action. This is true. For an agreement -- whether between two individuals or many nations -- to mean anything, it must constrain the future actions of those who sign it.

These constraints may be explicit parts to the agreement. They may also be implicit. According to Phillip Trimble, for example, the WTO erodes sovereignty in this fashion. “Although it is true that Congress may constitutionally pass legislation in derogation of WTO obligations, just as other parts of the federal government may violate WTO obligations without effective challenge under US domestic law...as a practical matter... the WTO’s preference for international standards and the certainty of sanctions for violations will inevitably induce government decision-makers to prefer compliance with international standards” (italics added)\textsuperscript{193} “The resulting practical devolution of decision-making authority to international institutions is the essence of the loss of national sovereignty.”\textsuperscript{194}

\textsuperscript{190} Under established constitutional law US courts give precedence to an act of Congress over an inconsistent international agreement if the act is subsequent in time. Similarly the courts have permitted the President to violate customary international law.” (Tiefer, Charles 2000)

\textsuperscript{191} The US’s first major trade treaty, the Jay Treaty with Great Britain depended on the willingness of the Congress to enact appropriations for its implementation, even after Senate ratification. This it only did reluctantly.

\textsuperscript{192} Page 49. Low.

\textsuperscript{193} page 2. (Trimble, Phillip 1997)

\textsuperscript{194} Likewise, although he does not believe this applies to trade agreements, Jeremy Rabkin argues that “the real threat is not that the US will be forced to act against the determined resolve of the American political system. Rather, the threat is that international commitments will distort or derange the normal workings of our own system, leaving it less able to resolve policy disputes in ways acceptable to the American people” (quoted in Rogowsky, Robert A., Linkins, Linda A. et al. 2001).
While the United States may indeed find its domestic behavior constrained, it could also find that in return, its overall ability to act is expanded. Paradoxically, therefore, these may be constraints that expand the options the United States has to act freely. By agreeing to constrain their own behavior, WTO Members constrain the behavior of others and this may enlarge the choices they can make. In an interdependent world, for example, the ability to participate in creating international standards may be more important than the ability to determine standards unilaterally.

After all, in general international trade provides countries with more choices about what to produce and what to consume. Without the assurance that their products will have entry to foreign markets, for example, America’s farmers may chose not to grow as much wheat and American industry may chose to produce fewer computers. Without the assurance that they will not be stopped at the border, America’s department stores would be less willing to stock imported products and America’s factories less willing to rely on imported inputs. Farmers, stores and factories may still chose to buy and sell domestically, but trade gives them more options and trade agreements help make these options more secure.

In sum, claims that the WTO authorizes penalties are (with the exception of export subsidies) false. Those who make this claim forget that violators have in principle failed to keep their part of a deal for which they received concessions from the plaintiffs. The WTO allows re-balancing through suspension of concessions to allow the plaintiff to redress some the harm from the breach, but it does not permit sanctions. Such suspension also provides countries with a de-facto opt-out mechanism that allows them to avoid compliance and is thus also a mechanism for dealing with the dangers of excessive judicial activism. The DSB has no authority to add to Member’s obligations and in any case, Members need not grant WTO rulings direct effect in their domestic law.

**Equity.** While a small country could still decide to employ retaliation to try to teach a larger trading partner a lesson and discourage future defections, it will find such actions relatively more costly to undertake than its larger counterparts because it cannot obtain favorable movements in its terms of trade. Smaller countries may also feel more vulnerable to other kinds of political pressures. Since they can do little to improve their terms of trade, economic theory suggests that small countries will on balance reduce their own welfare by suspending concessions. Their limited market power therefore gives the WTO Members less capacity to induce compliance through retaliation. This feature of the WTO system is however the mirror image of the advantages smaller countries may enjoy during negotiations from being able to free-ride on the MFN principle and for less developed Members, from special and differential treatment. Moreover, with the negotiation of the TRIPs agreement, developing countries acquired an area in which they are now able to retaliate more effectively. Indeed, in the bananas case, Ecuador requested authorization to retaliate against the European Union by suspending the intellectual property rights of EU exporters. 195

Despite their disadvantages in threatening retaliation, complaints by developing countries have generally been successful in obtaining compliance – presumably because

195 Despite being granted such authorization, Ecuador chose not to retaliate.
of the other motivations for compliance mentioned above. Nonetheless, the WTO is a system in which Members are supposed to have equal rights, and it would be desirable if the imbalance between small and large countries could be redressed.

In sum, overall the WTO has contributed to liberalization and been effective in establishing a system in which Members comply with the rules. It is actually remarkably deferential to national sovereignty and the difficulties smaller Members experience in retaliating are the mirror image of the benefits they derive in obtaining concessions. Nonetheless, introducing CLCs could eliminate the possibilities of the WTO contributing to protection, aid in compliance, respect national sovereignty and eliminate the unfair treatment for smaller Members.

**Final observations.** The WTO is an institution in which Members seek to promote their economic welfare by negotiating and enforcing a rules-based system that promotes trade liberalization. National self-interest lies at the core of the WTO system. Members join the organization and comply with its rules and rulings because, through their own decision-making processes (democratic or otherwise), on balance, they deem Membership and compliance in their interest. The WTO operates by consensus, and since every Member has the ability to veto any agreement, agreements can be presumed to reflect (so-called Pareto optimal) arrangements that make no Member worse off.

The consensus decision - making rule under which the WTO operates helps enhance its legitimacy by requiring all Members to concur with all agreements. But the vague and incomplete language that helps achieve agreement also leads to implementation problems. Members signing agreements appreciate they could find themselves on the losing side in WTO panel disputes. But even under these circumstances, they cannot be compelled to comply and have the option of accepting retaliation, providing compensation and living with whatever opprobrium is associated with failing to meet an obligation under international law.

The WTO is an agreement among sovereign nation states and, the belief that the organization enhances national self-interest is the ultimate source of WTO legitimacy. The WTO system in general and the dispute settlement system in particular, should be designed to enhance this belief. The rules analyzed in chapter 2 suggest that the remedies in the dispute settlement system are constructed in a way that aims at encouraging Members to sign agreements that are ex ante in their interest. Ex post, countries can again implement policies they view as in their interest. In principle, while it removes the incentives the system provides for non-compliance, retaliation does not punish. Unlike tort systems, in which damages are required in the event of breach, WTO remedies, at worst leave plaintiff countries in the same position they were prior to the agreement. By revealed preference, when they chose to opt out and to sustain their violations despite retaliation, defendants are in a position they prefer to compliance.

In the final analysis, Members of the WTO have to make hard choices. If they wish to sign agreements to cover more complex forms of behavior, they will face greater risk in the form of legislative interpretations that they cannot control or anticipate. *But this risk has to be weighed against the benefits that they derive from extending the rules of the trading system to new areas and policies.* To be sure, these risks would be

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196 According to Robert Hudec, “Over the GATT’s history, out of 22 complaints brought by developing countries that were based on a valid legal claim, satisfaction was achieved in 18 “.(Hudec, Robert E. 2002)page 82.
mitigated, first, by making sure that the draft language in agreements was clearer and second, by speeding up the process of negotiating agreements so that errors could be more readily corrected and ambiguities clarified. But both these worthy suggestions are more easily said than done.

An individual who signs a contract does not forfeit his or her liberty. Similarly, WTO Membership does not require countries to yield ultimate legal authority. WTO Members do not lose their ability to determine their own laws when they join the WTO. The WTO also cannot coerce compliance. The organization has no police force that investigates violations and no judiciary that imposes penalties on its behalf. Members found to violate an agreement do face consequences. Implementation problems aside, however, they are not punished.

But this is only the case if WTO remedies are allowed to operate as an escape clause. If in fact, they are calibrated to “compel compliance” and applied punitively, countries could ex post actually be worse off. To those who believe that the institutions rules reflect principles that like codes of ethics, have a higher ultimate moral authority this might not be a bad thing. But the gains from imposing compliance under existing agreements need to be weighed against the costs in discouraging future agreements and the toll such measures will take by fanning concerns that the organization is undermining national sovereignty.

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