
Introduction

The World Trade Organization (WTO) is under fire, and surprisingly, the latest attack is not from antiglobalization protesters. Instead, the onslaught stems from an improbable source—the world’s two most important trading economies, which 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 counterretaliation.¹ Such actions could damage the trading system in several ways: 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 hands of those who oppose the WTO as being an unwarranted intrusion on national sovereignty.

In April 1999, following rulings that the European Union had failed to bring its illegal banana imports system into compliance with WTO rules, the WTO authorized the United States to raise tariffs on \$191.4

1. When the WTO gives a member the right to respond to a violation, it is commonly described as a trade sanction, implying that the action is punitive. For clarity, this implication is made explicit in the book and the term “sanction” is reserved 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, the term will be used here 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.

million worth of European exports. Later that year, the United States targeted an additional \$116 million worth of European products because the European Union had failed to comply with an adverse judgment in the dispute over hormone-treated 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.²

After a prolonged struggle, the banana dispute was resolved, but in the interim the European Union 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 European Union successfully challenged the ETI. It sought, and in August 2002 received, WTO permission to increase tariffs to obliterate \$4.043 billion worth of US exports. The European Union has also successfully challenged US steel safeguards. At first it 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.³ It later reduced its planned retaliation to \$557 million (“EU Adopts Steel Tariffs But Delays Application,” *Inside U.S. Trade*, June 14, 2002).

Were the European Union actually to impose 100 percent tariffs on \$4 billion worth of trade because of the FSC, it would raise the average import-weighted tariff on US exports to the European Union by about 1.8 percentage points.⁴ 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 EU countries reduced their import-weighted average tariffs by an estimated 1.6 percentage points (Finger et al. 1996, 67). 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 costs 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.

2. 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.

3. The European Union 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 US steel tariffs. See “EU Moves to Prepare Retaliation on U.S. Steel Safeguard,” *Inside U.S. Trade*, March 22, 2002.

4. 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).

FSC retaliation would entail very high tariffs on a few products, and microeconomic theory suggests that, under reasonable assumptions about the behavior of supply and demand, the social costs of a tariff rise with the square of the rate. Thus a tariff of 2 percent inflicts four times the damage of a 1 percent tariff, and a tariff of 3 percent, nine times the damage of a tariff of 1 percent.⁵

This is not the end of the story.⁶ In mid-2003, the United States brought a case against the European Union on its ban of US exports of grain containing genetically modified organisms (GMOs). In addition, the Uruguay Round Agreement on Agriculture included a “peace clause” not to use the WTO Agreement on Subsidies and Countervailing Measures (SCM) to challenge subsidies in agriculture until the end of 2003, but when this clause expires, the United States could challenge EU agricultural export subsidies (worth \$6 billion in 2000) and ratchet up the feud yet another notch.⁷

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 United States won the banana and beef cases, thus inflicting political pain, the European Commission felt compelled to retaliate with the FSC case, despite the fact that, with the exception of Airbus, a very strong European constituency did not favor the case; indeed many EU multinationals benefit from the tax break. Moreover, by bringing the case, the European Union was breaking an implicit understanding that had stood for almost two decades.⁸

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 the FSC. Arbitration panels have taken the view that these authorizations need not be confined to the impacts

5. See, for example, Kenen (1994, 23).

6. For a discussion that places the bilateral WTO disputes in a broader context, see Bergsten (2001).

7. 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.” See www.wto.org/english/tratop_e/agric_e/negs_bkgrnd13_peace_e.htm.

8. According to Hufbauer and Newman (2002), “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 in response to aggressive American tactics in the banana and beef hormone disputes.”

of such subsidies on plaintiff exports. The \$4 billion the European Union was authorized in the FSC case was equal to the full cost of the subsidies the US Treasury provided. (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 20 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 of responding to violations. Four of these concerns will serve as the focus of this analysis: 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. Let's consider each of these concerns.

Increased Protection

The WTO is designed to promote freer trade. Given this objective, 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 can be counterproductive if it is more powerful in encouraging retaliation than it is in deterring violations.⁹ An upward spiral of retaliations with strong punitive elements could set off a trade war. The prospect that the European Union will accept US hormone-treated beef currently appears dim: this ban and now the US retaliation have been in place for a lengthy period. Such measures pose the danger of increased protectionism, leading 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 allowing plaintiffs to retaliate and/or requiring violators to pay fines.¹⁰

9. Indeed, the United States still has 25 percent tariffs on truck imports that date from the "chicken wars" in the 1960s!

10. According to the Meltzer Commission (IFIAC 2001), "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

Noncompliance

The recent series of rulings against the United States and the European Union and the authorization of retaliation highlight the countries' failure to comply with the rules.¹¹ Aside from the damage to their credibility when they preach the virtues of free trade to other nations but do not practice them, the behavior of these two large participants calls into question the WTO's ability to enforce a rules-based trading system. If the largest players do not stick to the rules, surely others will feel freer to do likewise. According to Petros Mavroidis (2000), for example, the persistent violations of WTO agreements suggest that the penalties for noncompliance 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 in reaching decisions, determining noncompliance, 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 and have an incentive to protract the dispute settlement process. As a result, some have advocated measures for speedier responses, 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 Understanding on Rules and Procedures Governing the Settlement of Disputes (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 WTO, the United States seriously undermined its sovereignty.¹²

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

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 pay an annual fine equal to the value of the damages assessed by the panel or provide equivalent trade liberalization."

11. Joost Pauwelyn (2000) likewise complains that WTO remedies are inadequate to enforce compliance. See also Brimeyer (2001).

12. According to David Bonior, "Worst of all it threatens to trivialize the political process in every one of our societies, by allowing private panels of the WTO to overturn the public policies of our nations" (quoted in Rogowsky et al. 2001).

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.”¹³ Similarly, Patrick Buchanan recalls with approval,

[O]n 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.*”¹⁴

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-treated beef.¹⁵ Yet the WTO has deemed this action illegal and authorized the United States 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 United States, for example, has lost a fairly large number of cases, leading to complaints in the US Congress that the DSB is exceeding its mandate.¹⁶ Critics argue that when the Uruguay Round agreement strengthened the WTO dispute settlement system, it dramatically increased the danger that the WTO rules will be determined by dispute panelists rather than WTO members. Claude Barfield (2001) and Marco Bronckers (1999), for example, maintain that a dangerous mismatch exists between the speed and efficiency with which the dispute settlement process acts and the lengthy delays associated with negotiating new rules. They fear that the lack of clarity in the rules leads to excessive judicial activism on the part of the panels, which inevitably try to fill the gaps and deal with the ambiguities negotiators create. Such actions, they argue, undermine national democratic decision making. Concern that the appeals board may go too far has led the US and Chilean governments to jointly 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.

13. Quoted in Jackson (2002). WTO opponents such as Nader routinely describe WTO retaliation as fines. According to Nader, “Once the WTO’s secret tribunals issue their edicts, no independent appeals are possible. Worldwide conformity or continued payment of fines are required.” See Wallach and Sforza (1999, 18).

14. See WTO’s Tentacles Tighten, July 25, 2001, at www.theamericancause.org/tentacles.htm.

15. For a detailed account, see Devereaux (2001).

16. For a discussion of US losses, see Leibowitz (2001).

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 reliance places smaller countries, without much market power, in a disadvantageous position.¹⁷ Even when authorized to do so, countries such as the Netherlands, Ecuador, and Canada have actually not implemented retaliatory responses perhaps because of 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 nondiscrimination, in reality 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.¹⁸ Those concerned about this inequity have also supported moves that would make retaliation a response enforced multilaterally.¹⁹ They would also eliminate retaliation in favor of requiring the violating country either to pay monetary fines or to provide a compensating reduction in other trade barriers (Breuss 2002).

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 central questions are explored in this study.

Plan of the Book

This study adopts a fairly narrow perspective, concentrating on WTO dispute settlement responses, particularly retaliation.²⁰ Other features of the WTO that have become increasingly controversial are not discussed in detail. Some of these broader controversies reflect concerns about globalization and the WTO's role in promoting it; some reflect narrower

17. For a discussion, see Hudec (2002), Pauwelyn (2000), and Mavroidis (2000).

18. 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.

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

20. For an excellent discussion of other issues, see Porter et al. (2001).

concerns about the manner in which the WTO dispute settlement system operates—in particular, questions relating to the transparency of its proceedings, participation by nongovernmental organizations, and participation in decision making. In addition, there is the question of excessive judicial activism already mentioned. While these are important issues, this study focuses on retaliation.

The WTO dispute settlement system of retaliation is controversial, in part, because there are different preconceptions about how a rules-based trading system 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 vein as contract breaches—that is, 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 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 2 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 precisely in allowing concessions to be “rebalanced” in response to findings of violations. Rebalancing is supposed to equal the level of “nullification or impairment” the violation causes. Strikingly, the retali-

tory 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 such rebalancing is permanent and applied on a most favored nation basis).

Upon close examination, this system most clearly achieves the goal of maintaining reciprocity. In addition, however, the system achieves several other goals *at the same time*, although it does so imperfectly. Rebalancing 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. But rebalancing is not properly viewed as a punitive sanction or punishment and 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. Ultimately, since retaliation or compensation are meant to be only temporary measures, an obligation to comply remains.

This WTO method of responding to infractions also helps encourage members to sign agreements they believe will be beneficial. Ex post, members are no worse off than they were had they not signed the agreement. Rebalancing allows the plaintiff to restore its position before the agreement, while the defendant will only persist in its violation if it is made better off. Rebalancing 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. 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. 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 3 explores how rebalancing becomes more punitive in practice than its theory might suggest. Indeed, members have contrived to use suspending 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 subsidies code 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 than 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 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 the Uruguay Round. Similarly, the friction over the domestic international sales corporations 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 antidumping enforcement have a long and sorry history. The major difference is that more of these disputes and retaliations have 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, but most reforms that improve the performance in one dimension worsen it in another. Eliminating rebalancing 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 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 the defendant would have to cooperate. Requiring retroactive compensation for infractions could reduce incentives for delay but might also discourage countries from assuming new commitments.

Chapter 5 presents a proposal for contingent liberalization commitments (CLCs) that 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 preannouncing 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 preselection would not violate the capacity of potential defendants themselves to select sectors and/or 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 rebalancing of concessions, and members would still have a temporary "opt-out" mechanism when experiencing compliance difficulties.

Chapter 6 concludes that both the United States and the European Union need to improve their domestic systems to ensure better compliance. They should focus as much effort on ensuring they comply with the rules as they do on finding fault with each other. In addition, changes in the DSU are being negotiated as part of the Doha development agenda (DDA). But there are few proposals for major changes to the system that command widespread support.

This analysis points to four changes that merit particular attention in the DDA. First, CLCs 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 United States should now obtain additional concessions from the European Union if the Union is still unwilling to import hormone-treated 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 and 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-term interest to do so, it helps reinforce the system's legitimacy. While duress could achieve conformity with the rules, in the long run it could erode support for the system. Accordingly, authorized responses to export subsidies should be equal to the trade lost by the plaintiffs.