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## Imperfect Practice in the US-EU Trading Relationship

ROBERT Z. LAWRENCE and NATHANIEL STANKARD

Before discussing US-EU disputes, it is useful to reflect on why the WTO dispute settlement system has recently become so controversial. This development is perhaps puzzling, since the Uruguay Round Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) is based on the same principles as GATT Article XXIII, which 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.<sup>1</sup> 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 comply or to provide compensation through reducing other barriers.<sup>2</sup> Some of this recent friction undoubtedly reflects widespread general concerns about globalization; some reflects concerns 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 the WTO Dispute Settlement Body (DSB) authorizes retaliation under the DSU, it

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*Nathaniel Stankard is a student at Harvard Law School. He served on the staff of the President's Council of Economic Advisers in 2000 and 2001.*

1. For an excellent overview of the history of dispute settlement, see Jackson (1998).
2. Authorization has however become more automatic. GATT Article XXIII only provides that the Contracting Parties *may* authorize suspension of concessions if they consider that the circumstances are serious enough. The DSU states that the DSB “*shall* grant authorization to suspend concessions” (emphasis added).

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 60 days, either by the original panel if available or an arbitrator appointed by the WTO director-general.<sup>3</sup> 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.<sup>4</sup>

## The Only Game in Town

The GATT system was indeed weak, not because of the size of the responses it could authorize but 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.<sup>5</sup> 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.<sup>6</sup> Finally, if they lost a case, defendants were under no obligation to explain how they intended to comply.

But these weaknesses induced, or at least provided an excuse for, members to resort to extralegal gray measures such as voluntary export

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3. See DSU Articles 22:6 and 7.

4. Indeed, in *Canada-Aircraft II* (DSU Article 22:6), Brazil requested authorization for countermeasures against Canadian aircraft export subsidies valued at \$3.36 billion. The arbitrator eventually authorized \$247.9 million.

5. 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 brought 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.

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

6. There was also no appeals process. If panels gave poor decisions, they could not be challenged. As Robert Hudec (2002) observed, "Blocking adoption was the only form of appeal there was."

restraints (VERs) and unauthorized retaliation.<sup>7</sup> Under the GATT, 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 (Bhagwati and Patrick 1990).<sup>8</sup> In these cases, the United States acted unilaterally, not simply in determining that retaliation was warranted but also in determining the value of the trade involved.<sup>9</sup>

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.<sup>10</sup> The WTO now provides countries with the unstoppable ability to obtain WTO judgments and blessing for suspending concessions in response to violations.<sup>11</sup> And in the Uruguay Round agreement, members explicitly agreed to abstain from VERs.

The changes made in the Uruguay Round have therefore raised the DSU’s profile and made it the focal point of international trade conflicts.

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7. Bagwell and Staiger (2000) 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.

8. The largest of these was probably the levying of a 10 percent tariff across the board on all Japanese exports in 1971—clearly a violation of the United States’ most favored nation commitments. In addition, in 1987, the United States imposed 100 percent tariffs on \$300 million Japanese exports to the United States, 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 United States raised tariffs on European exports in its dispute over hormone-treated beef. See Bayard and Elliott (1994).

9. The United States justified its actions on the grounds that WTO agreements covered many important trade barriers and the dispute settlement system was weak.

10. 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 have had a major impact on the two key costs that are relevant to the incentive to comply. First, the violator’s reputation would suffer quite similar damage in both cases. Second, the probability that the plaintiff would respond by suspending concessions was probably also quite similar, particularly since the most aggressive plaintiffs in this respect—the United States and the European Union—were inclined to retaliate even when they were not entitled to under the GATT. In fact, studies suggest that compliance under the two systems has not been significantly different. See, for example, Busch and Reinhardt (2002).

11. The DSU also set time limits for each stage of the proceeding, established an appeals body 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.

*Paradoxically, the very weakness and ineffectiveness of GATT served to channel frictions and retaliation elsewhere.*<sup>12</sup> While GATT itself may have appeared more stable prior to the Uruguay Round, the trading system as a whole was more likely to be disrupted.<sup>13</sup> It is significant, for example, that since the founding of the WTO, the United States 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 Section 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 United States and the European Union 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 United States or the European Union 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 European Union and the United States are both tough and demanding trade negotiators, which, in part, is 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 case, although the European 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.

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

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12. 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 et al. (1995, 370).

13. Schwartz and Sykes (2002) also make this point.

follow. Indeed, the Uruguay Round was as protracted as it was not because over a hundred nations were engaged in negotiations that covered 15 areas but ultimately because the United States and the European Union 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 counterretaliation. 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.<sup>14</sup> In the past, the ongoing battles between the United States and the European Union found many other outlets, from gray-area measures like VERs 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 WTO disputes between the United States and the European Union, which have resulted in actual or threatened retaliation, are not new. Indeed, quarrels over EU agricultural and food policies, US steel, and tax policy were all present prior to the Uruguay Round.

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 Agricultural Policy (CAP) even when faced with retaliation. The CAP lies at the heart of the European bargain and is a lynchpin of the European Union. Major changes in the terms of that bargain have not been possible merely because of external pressure.<sup>15</sup>

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14. We do not mean to imply all bilateral disputes have been channeled through the WTO.

15. In this case, the game between the United States and the European Union 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 United States and Europe, see Conybeare (1987).

Other knotty problems reflect fundamental policy differences. Food regulatory systems in the European Union and the United States are markedly different. In particular, an independent 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-treated beef, invoking the precautionary principle.<sup>16</sup>

Another basic policy clash is lodged in differing tax regimes. Countries in the European Union have territorial tax systems. Firms headquartered there pay European taxes only 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 (FSC).

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, antidumping, and safeguard actions to challenge European steel imports, which 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 US retaliation outside GATT. European responses to FSC mirror the responses to an earlier US tax provision—the domestic international sales corporation—in the 1970s. Recent European threats over US steel safeguards trod the path of the early 1980s. A detailed examination of each of these disputes reveals the extent to which domestic politics has trumped international trade agreements since the 1960s.

## Agriculture

The EU CAP has a long history of flouting trade agreements in the eyes of the United States. While the United States has avoided challenging

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16. Under this principle crops and food can be banned until they are scientifically proven to be harmless.

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.”<sup>17</sup> In addition, the policy was founded on a principled preference for EU products in EU 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),<sup>18</sup> 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 began to reduce the support prices on some commodities (in lieu of increased direct payments) and to 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 European Union attempted to support such producers while keeping the CAP intact. In addition, EU 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.

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17. This description of the CAP is based on Hasha (1999) and “EU Common Agricultural Policy,” Economic Research Service Briefing Room, US Department of Agriculture, [www.ers.usda.gov/briefing/europeanunion/policycommon.htm](http://www.ers.usda.gov/briefing/europeanunion/policycommon.htm).

18. These encompass three main mechanisms: target price, intervention price, and export subsidy. The target price is what the EU farmers would ideally get for their crops, including transportation costs. The intervention price is an annually adjusted figure at which the farmers can sell crops to public authorities; such crops usually go to EU storage locations. The export subsidy is paid to the farmers when world price falls below the EU internal price—the payment enables the farmers 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.

## Intransigence under GATT

The European Union has traditionally been noncompliant in disputes about agricultural policy, whether facing the United States or another country (Hudec 1998, Bayard and Elliott 1994). Under GATT, between 1960 and 1994, 50 of the 57 complaints against the European Union (88 percent) were over agriculture. Of the seven complaints against nonagricultural practices, the European Union offered concessions in six (86 percent). Of the 50 complaints against agriculture, concessions were offered in only 19 cases (38 percent). In contrast, the concession rate for agricultural and nonagricultural sectors was comparable for non-EU signatories (approximately 74 percent).<sup>19</sup> Some of the most stubborn US-EU disputes under GATT involve processed food, oilseeds, and other food exports in a series during 1981–82.

### Processed Food

The 1960s saw the first round of US actions against EU agricultural policy under GATT. One example was the (in)famous “chicken war” (Conybeare 1987). The United States complained after inadequate EU compensation for the withdrawal of certain agricultural tariff bindings resulted in unilateral US retaliation of \$44 million. This measure was thus a direct response to the formation of the Common Market. The European Union requested a panel to determine whether the level of retaliation was appropriate; it was lowered to \$26 million.<sup>20</sup> 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 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 European Union; the United States won the case. Despite this defeat, the

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19. See Davis (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.

20. 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 EU obligations. However, US exporters quickly adjusted, and the United States withdrew the complaint when industry pressure subsequently diminished.

European 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 ruled against the European Union, but it blocked the adoption of the panel report. Retaliation was threatened, and a negotiated agreement was reached in December 1985. However, the European Union violated the agreement in 1988, and another agreement in 1989 was needed to avoid US retaliation.

### Oilseeds

Accompanying the 1976 US complaint against EU tomato products was another case concerning feed/dairy products. The temporary regulation in that case simultaneously relieved a surplus of dairy products in the European 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 European Union, initiated a GATT panel despite EU 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 again involved soybeans) became the subject of a lengthy dispute over oilseeds.

In 1988, responding to the concerns of domestic oilseed producers about the level of EU subsidies, the United States initiated a Section 301 action and requested a GATT panel. The following year, the panel determined that the EU practice violated EU obligations; the European 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 European Union implemented a new measure that was unsatisfactory to the United States.

In 1992, a panel again heard the case, and again found the EU measure inconsistent with EU obligations. When the European Union 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 European Union blocked the action. Consequently, the United States announced its intention to impose prohibitive tariffs on \$300 million of EU imports. This retaliation was averted by an agreement that limited the amount of land that could enjoy EU 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 EU agricultural policy; three proceeded to GATT panel decisions that were blocked. The United States stopped the adoption of a no-decision ruling on wheat flour subsidies. Panels ruled against the European Union on pasta subsidies and preferential tariffs on Mediterranean citrus products.<sup>21</sup> The European Union blocked the adoption of both reports.

The United States unilaterally retaliated in the citrus case against EU pasta exports, and the European Union counterretaliated. 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 US industry enough to allow it to supply the entire Egyptian market for a year. The European Union, after calling for a GATT panel on the US subsidy, voluntarily restricted its wheat flour exports. In September 1987, a negotiated settlement ended the flour dispute as well.

### **Intransigence under Section 301**

Many of the GATT actions in the 1970s and 1980s began as Section 301 actions;<sup>22</sup> 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 European 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 complaints.

The pattern of EU intransigence is present in non-GATT Section 301 cases as well—“concessions” were ineffective or replaced with new practices in cases concerning EU 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 European Union implemented quotas on soybean and soybean oil as part of Spain and Portugal’s accession to the European Union. Considering the GATT process to be too cumbersome, the United States threatened retaliation. After responding with its own threats, the European Union finally agreed to concessions of \$400 million over four years. The limited timeframe of the concessions has necessitated renegotiation more than once.

### **Intransigence under the WTO**

Further US action against certain CAP subsidies has been avoided because of the Uruguay Round’s extension of the “peace clause,” an agree-

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21. This was also the subject of an informal complaint about EU tariff preferences for Mediterranean citrus products in the 1970s. The matter never reached a GATT panel and was “settled” in 1973.

22. See Bayard and Elliott (1994).

ment not to use the WTO Agreement on Subsidies and Countervailing Measures (SCM) against a set of agricultural policies.<sup>23</sup> The peace clause is set to expire at the end of 2003. However, this has not prevented the United States from challenging other EU agricultural practices in the WTO.

The most acrimonious dispute between the United States and the European Union has been a US complaint against the EU 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 EU producers, the lengths to which the European 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 United States Trade Representative (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.

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 EU intransigence on agriculture,<sup>24</sup> but the result is always the same: the CAP is a beast of extraordinary inertia.

## Health Standards

EU 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

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23. See USTR (1996) and similar reports for subsequent years. Also see Cadot and Webber (2002) and Rosegrant (1999).

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

fought on the battleground of the role of health and safety standards<sup>25</sup> 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-fed cattle. The European 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 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 European Union claimed it would counterretaliate against several US agricultural products, the United States then postured that it would block all imports of EU beef. The US position was rooted in reciprocal meat inspection stipulations of the 1988 Trade Act and encompassed some \$450 million of EU beef products.

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

Aside from the minor concessions on pet food and certifying certain US exports as hormone free, the dispute and accompanying retaliatory measures dragged on until June 1996, when the European 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 satisfactorily bring its law into compliance with 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.<sup>26</sup>

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25. See Bayard and Elliott (1994) and Devereaux (2001) for more detailed accounts.

26. Another dispute on EU 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 European Union blocked the request

As in agriculture, domestic politics in the European Union constrained EU acquiescence on beef and the larger question of health standards. The power of European consumer groups suggests that the European Union will not change 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.

## 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 EU and US steel industries in the 1970s created new pressures on trade relations (for more on this section, see Hudec 1988, Bayard and Elliott 1994, Lindsey et al. 1999, Hufbauer and Goodrich 2003, and the USTR Web site, [www.ustr.gov](http://www.ustr.gov)). While a 1976 Section 301 petition against an export agreement between Japan and the European Union was aborted, two major disputes developed in the early 1980s. First, in 1982 US integrated steel producers petitioned the US Department of Commerce to investigate numerous EU manufacturers for dumping violations or subsidization. Several EU steel companies (particularly in Belgium, France, and Italy) were found to be significantly subsidized, and the United States threatened countervailing duties. Instead, in the same year the US Department of Commerce investigation commenced, a VER was established for the European Union as a whole and unilateral US action averted. Second, also in 1982, complaints by US 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 US exports. Another VER was negotiated in 1984, ending EU 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 Section 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 souring when

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for a time sufficient for a settlement to make any GATT decision irrelevant. US 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 European Union blocked the request again. Instead, another settlement was negotiated in 1992 that purported to resolve the differences between US and EU meat inspection requirements.

negotiations for the Multilateral Steel Agreement broke down. In 2001, the Bush administration, responding to complaints from both integrated producers and minimills, 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 Section 201 order with the United States, the European Union requested a WTO panel in May 2002. The European Union claimed 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 US 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 US actions under the WTO's dispute settlement mechanism.

## **Tax Policy**

The EU complaint to the WTO about the US FSC is the largest trade dispute threatening economic relations across the Atlantic (for more on this section, see Hufbauer 2002 and Hudec 1988). After an adverse Appellate Body ruling, 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 US exporters. In response, the United States 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 the DISC worked. The United States demanded that all four cases be linked together before a single GATT panel. While the panel eventually ruled in 1976 that all four defendants were guilty, many countries still considered the US policy to be the only truly illegal practice. Neither the European defendants nor the United States allowed the ruling against them 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 Community agreed to the adoption of both panel reports as qualified by a GATT Council understanding. 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 European Community and other GATT signatories threatened sanctions if the United States did not change its tax regime. In 1984, without conceding that the DISC was noncompliant, the United States replaced the DISC with the FSC. The FSC was tailored almost explicitly to fit the terms of the 1981 GATT Council understanding.

Fourteen years later, in 1998, the European Union requested that 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 European Union 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 it was enacted. After adverse panel and Appellate Body rulings, the United States attempted compliance with Extraterritorial Income Exclusion Act (ETI). Even before its enactment, the European Union condemned the ETI as noncompliant. In August 2001, a WTO panel again ruled against the United States; the Appellate Body affirmed. The European Union then sought and received authorization from WTO arbitration to suspend concessions of \$4 billion. However, the European Union has indicated it will wait some time before retaliating.

Unlike the previous three examples, US tax policy is marked more by foot-dragging than intransigence. The United States clearly wants to make sure its corporate tax code is competitive with Europe’s and unlike the situation for commodities such as steel or agriculture, that goal can be achieved in many ways. 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 Congress and the administration have indicated a willingness to comply.

Despite such efforts, US 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 US trade legalism. Before the DISC complaint, the European Union largely considered GATT a diplomatic endeavor. US action under GATT panels was met with rhetoric arguing against the legalization of international trade. Therefore, many thought the DISC suit to be the whip the European Union hoped would discourage the US legal zeal. Similarly, the WTO complaint against the FSC was

seen as a response to the beef and banana cases, unilateral US 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.

## 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.<sup>27</sup> As the practice and inertia of transatlantic trade disputes have remained, the world has changed dramatically. Before 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, the United States could not force the adoption of a GATT panel ruling, so it negotiated agreements that largely controlled problems with the CAP. Now, many of the same problems remain, but the United States can resort to a dispute mechanism that either forces the European 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 European 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 at the end of 2003, many of those subsidies could become fair game under the SCM. Given its demonstrated historical commitment to rein in the CAP, the United States can be expected to pursue at least some cases in the WTO. The European Union’s unrelenting case against US FSCs 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 European Union

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27. See also Pettersman (2000).

listen to consumer interests on other issues. Disputes over US steel policy used to be channeled through VERs; now such measures are illegal under the WTO. EU complaints about US 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, US pressure on EU agricultural policy (bananas) and health standards (beef) has induced the protracted debate over the 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, that the US-EU relationship is strong enough, and that one system can indeed handle all this acrimony and history. 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 European Union in agriculture and food, and in the case of the United States in administered protection. Like charity, compliance begins (and ends) at home. Both the United States and the European Union 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.<sup>28</sup> The need for a similar commission to examine domestic actions is surely no less great.

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28. This draws on Destler (1995, 253).