

---

## Options for Change

The 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 prenegotiated 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, offer 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 Rebalancing

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?<sup>1</sup> Such a system would have several advantages—indeed, it would mitigate three of the

---

1. The case for such international systems is made in Chayes and Chayes (1995).

four problems that have been identified: (1) the WTO would not be in the business of approving protection, (2) members would not be subject to trade retaliation or penalties—they would comply with WTO agreements in the same way they do with other binding international treaties, and (3) 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, thus removing 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 2 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, governments can lock in their commitments to policies that can provide assurance to private actors making long-term resource allocation decisions.<sup>2</sup>

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

---

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

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 later.)

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. And it would help rectify the imbalance in the current system that favors large countries with market power.

However, this solution requires the defendant’s cooperation. The difficulties of negotiating compensation that both sides agree on could thwart this alternative system. The virtue of suspension is that the plaintiff can undertake it unilaterally. Giving the plaintiff in a case *carte blanche* to select the products for liberalization would lead to strategic gamesmanship that might limit the value of concessions. To deal with this problem, Joost Pauwelyn suggests allowing the complaining party to choose the tariffs that it would receive as compensation. However, this solution would undoubtedly be politically objectionable since it would entail countries giving up the right to set their own trade barriers. It would surely represent an unwarranted intrusion into national sovereignty, and WTO members are extremely unlikely to 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 punished. “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 Mavroidis (2000) 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 hormone-treated beef 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, it will probably take the WTO Dispute Settlement Body (DSB) about 18 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 (2000), WTO obligations increasingly 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." He mentions the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) and the Agreement on the Application of Sanitary and Phytosanitary Measures (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? Fines could also be used to compensate plaintiffs for harm done by the violation before the adoption of the ruling.

A more punitive system would provide greater incentives for compliance with existing agreements but 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 reinforce 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 foreign tariffs of much higher magnitude), they might prefer not to take the risk of agreeing in the first place. The current system assures countries 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 (2001b) 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. In contrast, a system based on penalties could result in each tit being met by two tats, creating a momentum for conflict escalation rather than containment.

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 very strong political obstacles exist. 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 foreign sales corporation (FSC)/Extraterritorial Income Exclusion Act (ETI) case are so large that many in the United States have argued that it would be too disruptive for the European Union to retaliate.<sup>3</sup>

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 comply suffer no consequences. The delays in the dispute settlement process may create incentives and opportunities for noncompliance. Reparations might indeed lead to more

---

3. Even large countries will be unwilling to retaliate beyond levels associated with rebalancing concessions. Assume countries start with a noncooperative 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 to the initial level, thereby reneging on the agreement. The most the other would like to raise its tariff is also back to the 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.

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.

## 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 dispute settlement understanding. Fines have the virtue of avoiding additional trade protection.<sup>4</sup> 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 (Dam 1970, 368–73). 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 fails to directly compensate exporters. In contrast, monetary compensation avoids the damage to importers and if redistributed directly to exporters, would allow plaintiff governments to directly 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.

However, such a system has problems. The first is deciding how to place a monetary value on violations. Lawyers have considerable experience with this problem since the task of attaching monetary values owed

---

4. 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.

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 establish a system that avoided punitive or arbitrary measures and estimate the monetary equivalence of trade obligations in order to implement the notion of expectation damages. This approach 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-treated 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 competitively, this calculation 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 studying 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.<sup>5</sup>

A second practical problem would be 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 appropriate 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

---

5. These systems are discussed in Schwartz and Sykes (2002).

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. Nations choosing not to retaliate could 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 rebalancing 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 its rules could cover. 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.

## **Preauthorized Compensation: Contingent Liberalization Commitments**

Each of the options considered thus far has defects: eliminating rebalancing would reduce incentives for compliance; multilateral retaliation creates a system dependent on the willingness of members to raise trade barriers; confining rebalancing to compensation depends on the willingness of defendants to provide compensation acceptable to the plaintiff; and 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 another approach would be more effective in dealing with the problems while preserving the essential character of the system: contingent liberalization commitments (CLCs).

In this approach, WTO members would be given the option of offering a preauthorizing compensation mechanism during the Doha Round negotiations. These offers would be included in the multilateral negotiations. If a country's offer is accepted, in the 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 choose from several options in making their CLCs. They could indicate a willingness to provide (selective) financial compensation, they could agree to provide across-the-board (most favored nation) 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 specializing in particular exports (for example, 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. Countries that are currently unable to effectively threaten retaliation would have a viable mechanism to exercise their rights to compensation. Compliance incentives would be improved. 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 or 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 preselection 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 support in defendant nations in which collecting such payments is 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 rebalancing 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 harmed simply by the threat of having their protection removed. At the margin this adverse effect could discourage investment and other forms of expansion in these industries, which 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 CLCs 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' CLCs 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 with 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 CLC system would surely be increased.

In addition, since 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 feature 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 predesignating CLCs could lead countries to be less willing to liberalize in the first place, which is certainly a possibility. But it needs to be weighed against the danger in the current system that retaliation and counterretaliation in unresolved cases could eventually lead to a substantial increase in protection. The more significant this problem becomes, the more attractive a CLC system will become. Indeed, although I have advocated voluntary CLCs, 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 United States has been authorized and has retaliated against the European Union in the hormone-treated beef case to the value of \$119 million. The European Union has been authorized to retaliate in the FSC case by \$4 billion. In the current system, both the United States and the European Union could raise tariffs by the amount authorized. Instead, if the system applied netting out, the European Union would simply be authorized to retaliate by \$3.88 billion, and the United States 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. Over time, 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 comply 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.