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Introduction: trade policy flexibility in the WTO – vice or virtue?

> But to my mind, though I am native here
> And to the manner born, it is a custom
> More honour'd in the breach than the observance
>
> William Shakespeare, *Hamlet*, Act I, Scene 4

This study deals with the rational design of trade policy flexibility and remedies in the World Trade Organization (WTO). It examines whether, and under what circumstances, contractual non-performance (or escape) may be considered *more honour'd* than the *observance* of previously made trade commitments, at what cost for the breaching Member, and with what effect for the global trading order.

The WTO[1] is a multilateral trade agreement and as such the international equivalent of a contract.[2] It lies in the nature of a trade accord that governments accept far-reaching trade liberalization concessions, which severely limit their domestic policy discretion in the future. Prior to the conclusion of the Agreement, countries did not possess full knowledge of the nature, probability of occurrence, or impact of future events. Nor were they able to anticipate the possible trade policies and instruments that their trade partners might concoct in the course of the contractual performance. Asymmetrical information settings, uncertainty over future environmental contingencies, bounded rationality,

[1] Throughout the course of this study, the terms "WTO" or "the Agreement" will be used interchangeably as shorthand for the bundle of multilateral contracts that are known as the Uruguay Round Agreements. These Agreements include the Marrakech Agreement ("WTO Agreement" or "WTO Charter"), and all the treaties mentioned in Annexes 1–4 to the Marrakech Agreement.

[2] The WTO Appellate Body (AB) in *Japan – Alcoholic Beverages*, WT/DS 8,10,11/AB/R: 16, expressly stated that "the WTO Agreement is a treaty – *the international equivalent of a contract*" (emphasis added).

limited resources, or mishap, or a mix of the above, at the time of its conclusion make the WTO an inherently incomplete contract.[3]

A defining feature of incomplete contracts is that they contain gaps: important contingencies (eventualities, future conditions, or "states of nature") are not considered in the terms of the original contract, and thus are not exhaustively and unambiguously specified *ex ante*, i.e. at the time the parties concluded the contract. *Ex post*, during the performance phase of the contract, gaps may leave gains from trade unrealized. This, in return, may create room for "regret" (Goetz and Scott 1981) whenever unanticipated and unforeseen developments, or shocks, occur.[4] In the context of international trade a shock, such as a protectionist backlash within a country, may seriously threaten some domestic import-competing sector or export industry, and therewith jeopardize welfare and/or employment of certain groups of society, or economic growth and social cohesion at large. Performance as previously agreed upon may then no longer be either desirable for the affected WTO Member nor mutually efficient.[5]

[3] The insight that the WTO contract is incomplete in important aspects is neither original nor particularly new. This view of the WTO has recently gained acceptance and acknowledgment among WTO scholars (e.g. Downs and Rocke 1995; Dunoff and Trachtman 1999; Ethier 2001a; Hauser 2000; Hauser and Roitinger 2003, 2004; Herzing 2005; Horn, Maggi and Staiger 2006; Lawrence 2003; MacLeod 2006; Mavroidis 2007; Rosendorff 2005; Rosendorff and Milner 2001, to name only a few). There is a rapidly expanding literature that discusses or models the WTO as an incomplete trade accord between sovereign nations. (Recent contributions include Bagwell 2007; Bagwell and Staiger 2005b; Ethier 2001a; Horn, Maggi, and Staiger 2006; Howse and Staiger 2005; Kucik and Reinhardt 2007; Lawrence 2003; Rosendorff 2005.)

[4] A signatory experiences regret whenever an *ex ante* envisioned transaction value is not realized in the light of the newly revealed information. An unanticipated contingency arises which, had it been known to signatories at the outset of negotiations, would have changed the content of the original contract. Mahoney (1999, p. 117) aptly states: "A contract is an exchange of promises … and the parties enter into it because each values the thing received more than the thing foregone. These values are based on expectations about the future because some or all of the contractual performance will occur in the future. When the future diverges from what a party expected, he may conclude that the performance he will receive under the contract is no longer more valuable than the performance he must provide. He has … experienced a 'regret contingency' and now would prefer not to perform and not to receive the promised performance from the other party."

[5] To grasp the concept of *ex post* regret, consider the simple example of a fixed-price contract that obliges one party to produce and the other party to buy a product. An earthquake destroys the production facilities and makes delivery as prescribed extremely costly: the producer will prefer not to perform; by means of a side payment to the buyer (exceeding the latter's personal value of the good) both parties can be made better off by not conducting the envisaged transaction (see Shavell 1980, note 4).

When drafting the original accord, signatories to any trade agreement have shown a profound interest in allowing shock-ridden Members to withdraw from previously made concessions rather than forcing them to rigidly observe the letter of the contract. But how exactly should rules of flexibility be organized and designed? Should a shock-afflicted party be allowed to withdraw fully or partially, temporarily or permanently, at any point in time or under strict preconditions, at its own discretion or with prior consent of the affected party/parties? What is the appropriate price for such deviation from contractual obligations? And how can rules of flexibility be credibly enforced against opportunistic and ill-meaning abuse?

This study is primarily concerned with two issues: first, why are the current WTO flexibility mechanisms flawed? Second, how should they better be organized instead? While many commentators remain largely conjectural about the imminence of the WTO's problems in its system of contractual escape and dispute settlement, we aim to provide a structured, differentiated, and comprehensive approach towards the issue of trade policy flexibility in multilateral trade agreements. In the course of this study, starting with the next chapter, we will assess exactly where the WTO system of *ex post* escape is at fault, with what effect, and how it should be improved.

Meanwhile, by way of an introduction to the topic of trade policy flexibility and enforcement in the WTO, this chapter proceeds as follows: section 1.1 briefly reviews some major concerns that commentators have voiced about the way trade policy flexibility and enforcement are currently organized in the WTO. Section 1.2 establishes the ground-rules for any successful system of flexibility in trade agreements. In particular, it addresses the intricate connection between any rule of contractual *ex post* adjustment of concessions, the remedies for doing so, and the initial willingness of signatories to cooperate in trade matters. Section 1.3 summarizes the objective of this study and formulates its central research questions. It is followed by a reader's guide to this book. Then, in section 1.4. we present an overview of this study's content and summarize some of the key findings. Section 1.5 provides a short literature review, describing in particular in which aspects our approach to the topic of trade policy flexibility and enforcement differs from WTO scholarship.

1.1 Trade policy flexibility in the WTO: a system at fault

The framers of the WTO were acutely aware of the presence of contractual gaps and the inevitable uncertainty in the economic environment.

To that end, the WTO contract provides countries with a means of departing from previously agreed obligations. In order to seize gains from regret and to deflate the build-up of domestic pressure against trade liberalization, the WTO contract includes certain trade policy flexibility instruments that permit one party (the "injurer") to (partially) default, i.e. to step back from ("modify or withdraw") contractual performance obligations it had previously agreed to. The injurer can do so if certain preconditions are met, most notably that of compensating the parties affected by such back-tracking behavior (the "victims").[6]

The WTO provides for several formal, de iure, trade policy flexibility mechanisms.[7] Examples in the General Agreement on Tariffs and Trade (GATT)[8] are Art. XII (*Restrictions to Safeguard the Balance of Payments*, applicable to developed countries only), Art. XVIII (infant industry protection and balance of payments crises; applicable to developing countries only), Art. XIX (*Emergency Actions on Imports of Particular Products*, also known as the "safeguards clause"), Art. XXVIII (*Modification of Schedules*, also known as tariff renegotiation), and – arguably – Arts. XX and XXI (*General Exceptions* and *Security Exceptions*).[9] As our analysis in Chapter 4 will show, common to these de iure flexibility mechanisms are rather high levels of conditionality (enactment preconditions and scope of application),[10] as well as relatively modest indemnity payments to the

[6] No positive or negative connotations are implied in calling the parties "injurer" and "victim." Consistent with standard law and economics (L&E) literature, the terms injurer and victim are used as roles (or "types") that signatories can assume throughout the performance phase of a contract: injurers are parties that long for *ex post* adjustments, and victims are parties affected by any of the injurer's subsequent decisions.

[7] Trade policy flexibility tools are sometimes also called "opt-outs," "trade contingency measures," "safety valves," or "escape clauses." Later on in the study we will explain why none of these terms is sufficient in capturing the entire realm of trade policy flexibility mechanisms.

[8] Similar examples of trade policy flexibility instruments can be found in other WTO Agreements, such as the General Agreement on Trade in Services (GATS), the Agreement on Technical Barriers to Trade (TBT), or the Agreement on Agriculture (AoA).

[9] Whether GATT Arts. XX and XXI should really be seen as flexibility mechanisms will be discussed at p. 218 below.

[10] The level of conditionality of a flexibility instrument is composed of two elements, the first being enactment thresholds. Enactment thresholds are contingency-related preconditions that the injurer has to surpass before making use of a flexibility mechanism. Enactment costs are sunk, and compensation payments do not form part of conditionality-related costs. The second element of conditionality is the scope of application, the contractual deployment strings attached to the use of a trade policy flexibility mechanism. The ease of use of a flexibility instrument is thus a function of the level of both conditionality and scope of application.

affected victim countries (in some cases, such as under GATT Arts. XII, XV, XX, or XXI, victims are not compensated at all).

In addition to these de iure escape clauses there are various informal, de facto, flexibility tools available to WTO Members. Trade policy tools such as voluntary export restrictions (VERs), orderly marketing agreements (OMAs), antidumping (AD) and countervailing duty (CvD) measures, subsidies, or a violation of the Agreement are frequently used by WTO Members as ways to escape initially made trade liberalization commitments. Resort to these instruments is often in contravention of the letter of the law, or at least the spirit of the Agreement. Given that these de facto trade policy flexibility mechanisms happen more or less in the shadow of the law, their use is hence characterized by lower enactment costs, far-reaching scope of application (especially in the case of violation of the Agreement), and indemnity payments (damages) that are strictly lower than commensurate with the damage caused.[11]

The way trade policy flexibility is currently organized in the WTO raises a string of serious systemic issues.[12] As an example: why do certain WTO Members prefer the use of AD and CvD measures over the use of the designated escape clause of GATT Art. XIX, what are the consequences of such behavior, and what can be done to reverse this trend (see e.g. Barfield 2001; Barton *et al.* 2006; Blonigen and Bown 2003; Bown 2001; Finger, Hall and Nelson 1982; Finger, Ng and Wangchuck 2001; Messerlin 2000; Palmeter 1991b)?

Next, what is the logic of sanctioning legal escape options and contractual defection in the same manner? Note that the WTO applies the same remedy – substantially equivalent damages – to legitimate nonperformance (e.g. GATT Arts. XIX, XXVIII) as well as to a violation of the Agreement (DSU Art. 22.4).

Further, what is the WTO's rationale for having a whole arsenal of *substitutive* escape clauses that have overlapping scopes of application? In a given situation, a Member has the choice of resorting to GATT Arts. XIX or

[11] As will be shown later in more detail, many informal escape mechanisms, such as AD and CvD measures, do not provide for any compensation of victims at all. Even utilizing "violation-cum-retaliation" as an escape mechanism (i.e. breaching the Agreement, losing a trade litigation, and withering retaliatory measures enacted by the victim) does not add up to commensurate damages due to the way dispute panels have interpreted Art. 22.4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU).

[12] Many of these issues have been addressed by WTO scholarship; some have already been subject to litigation in high-profile WTO disputes. We leave a detailed discussion for later chapters (especially Chapters 5 and 6).

XXVIII, VERs/OMAs, an AD measure (under GATT Art. VI and the Antidumping Agreement (ADA)), or violation of the Agreement. Various flexibility mechanisms only differ in their level of conditionality and the compensation payable to the victims. It is thus evident that an injuring country will always go for the escape instrument which promises "most mileage," i.e. the fewest enactment costs, the lowest compensation, and the largest scope of application. As a consequence, instead of engaging in legal contractual escape in situations where *ex post* adjustment is mutually beneficial, Members act opportunistically and opt for informal protectionist escape instruments. They engage in de facto escape such as antidumping or countervailing duty actions, and risk losing the ensuing disputes (see e.g. Bown 2001, 2002a, 2002b, 2004; Finger 1998; Finger, Ng, and Wangchuck 2001; Lawrence 2003; Roitinger 2004; Schropp 2005; Sykes 1991).

Another concern is the limited scope of existing de iure escape clauses. Numerous scholars have argued that de facto breaches of WTO obligations often occur because of the rigidity connected to the enactment of formal escape mechanisms, such as GATT Art. XIX. Mavroidis (2006) states that the more rigid and "expensive" (in terms of remedies) contractual safeguards are, the less they are used. According to Mavroidis, WTO Members are more likely to violate the WTO treaty if rigid safeguards deny them the necessary "breathing space."[13] The current WTO safeguards regime allegedly does not address Members' needs for policy flexibility (see also Horn and Mavroidis 2003; Roitinger 2004; Sykes 2003). As became clear in the course of the *EC – Hormones* case,[14] the European Communities, for political or health reasons, wished to step back from a commitment they had made under the Agreement on Sanitary and Phytosanitary Measures (SPS). This endeavor, however, is not considered in any formal WTO escape clause. Hence, lacking any official means of withdrawing from existing concessions, the EC claimed to see no alternative to maintaining its violation of the Agreement.

In summary: while it is well-established that contractual escape mechanisms are an indispensable feature of multilateral trade agreements, it is the contention of many WTO pundits (trade practitioners, international lawyers, economists, and international relations scholars

[13] The *US – Steel* case, for example, patently revealed that Art. XIX safeguards and violation of the Agreement can be used as ready substitutes (*Definitive Safeguard Measures on Imports of Certain Steel Products*, WT/DS 248, 249, 251, 252, 253, 254, 258, 259).

[14] *Measures Affecting Livestock and Meat (Hormones)*, WT/DS 26 and 48, and *Continued Suspension of Obligations in the EC – Hormones Dispute*, WT/DS 320 and WT/DS 321.

alike) that the current system of trade policy flexibility in the WTO does not provide for adequate contractual escape, and therefore is profoundly flawed. In the course of this study we will show that the current system sets the wrong incentives for injurers, and undercompensates victims of escape. This situation may consequently lead, or already have led, to excessive breach, undercommitment (less-than-ideal *ex ante* trade liberalization concessions) by WTO Members, and an atmosphere of mistrust within the Organization. As a result, disgruntled and disillusioned Members have resorted to retaliatory strategies within and outside the realm of the WTO (e.g. retaliatory antidumping or retaliatory litigation). It could even be argued that the flawed system of trade policy flexibility and enforcement has resulted in a destabilization of the entire multilateral world trading system.

1.2 Some definitional groundwork: connecting issues of breach, remedies, and commitment level in incomplete contracts

But why exactly is the current system of WTO flexibility mechanisms flawed and what can be done to remedy the situation? One can only grasp the full extent of the flexibility debate if it is preceded by a discussion of the intricate connection between trade policy flexibility, contract breach, enforcement, and *ex ante* commitments. Figure 1.1 prepares some

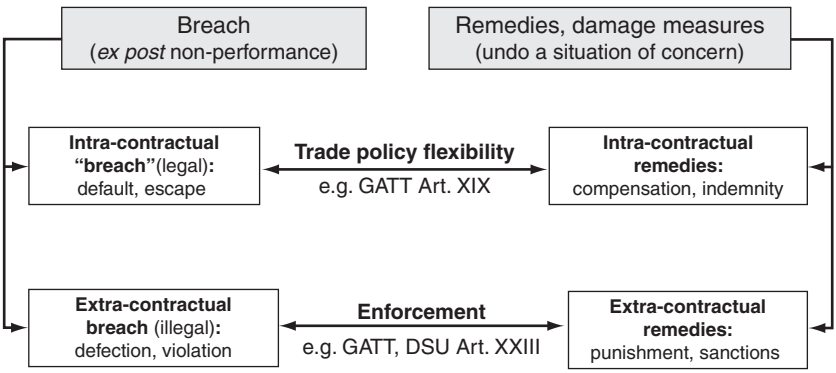

Figure 1.1 Non-performance (breach and remedies) in incomplete contracts
Note: This chart depicts the relationship between *ex post* non-performance (breach) and the remedies such breach entails. Depending on whether the breach is intra-contractual (legal), or extra-contractual (illegal), a breach-cum-remedy combination is either called a "trade policy flexibility mechanism" or an "enforcement instrument."

definitional groundwork. It captures our general understanding of breach and remedies in trade contracts. In particular, it illustrates the important interlinkage between *ex post* adjustment (non-performance) and enforcement in incomplete contracts.

Most contracts, no matter how trivial the underlying transaction is or how well the agreement specifies the rights and obligations of the signatories, have implicit or explicit rules of non-performance, that is about breach and remedies. Whilst the definitional terms are not entirely satisfactory, *breach*[15] and *remedies*[16] will be used in a generic sense so as to delineate any form of contractual *ex post* adjustment, and any behavior towards undoing a situation of concern, respectively.

Ex post non-performance, or breach, of previously agreed contractual commitments can occur in two ways: first, if non-performance is contractually specified and therefore legitimate ("breach"), this arrangement – called escape, default, or excuse from obligations – forms an integral part of the contract. Non-performance as agreed upon then represents intra-contractual, permissible, behavior, not a violation of the terms of the accord. Generally, escape rules can be organized as opt-out mechanisms, or as renegotiation clauses.

A second non-performance possibility is constituted by extra-contractual, illegal, behavior. As a convention, we call this behavior *defection* or *violation of the contract* (other terms would be infringement, reneging, deviation, or contractual misdemeanor).

[15] The term *breach* is somewhat misleading, since in everyday terminology it bears the connotation of extra-contractual, illegal behavior. Yet in contract theory, breach is often used to describe lawful opt-out clauses, or liability rules, which allow the injurer to unilaterally decide on contractual performance and non-performance at its discretion. In order to avoid confusion, we will use breach as a generic term for any kind of non-performance. Whenever the word is used as an intra-contractual sense (such as in "efficient breach"), we will put it in quotation marks ("breach").

[16] Following standard contract-theoretical terminology, the term *remedy* is used in a comprehensive sense, so as to cover any action aimed at undoing unanticipated behavior by one contracting party. It is the generic term encompassing intra-contractual remedies (compensation, indemnity) and extra-contractual sanctions (punishment). Our understanding of the term "remedy" is notably different from the customary extra-contractual connotation it bears in the WTO literature, or, for that matter, in public international law in general, as spelled out in the ILC Draft on State Responsibility (see Grané 2001; Mavroidis 2000; Vazquez and Jackson 2002). In the WTO context the notation "remedies" is usually used in a narrow sense as legally sanctioned responses pursuant to *non-compliance* by the injuring WTO Member whose practices have been multilaterally condemned (Mavroidis 2005). DSU remedies, narrowly defined, are comprised of the WTO legal "countermeasures," namely retaliation and tariff compensation (Mavroidis 2000, p. 800).

Every act of contractual non-performance is necessarily connected to a remedy rule, or a rule of damage. As Figure 1.1. demonstrates, there are intra- and extra-contractual remedies payable to the victim of a violating measure. Those remedies in connection with legitimate escape clauses will be called *compensation* or *indemnity*. Extra-contractual remedies will be termed *punishment* or *sanctions*.[17] In general, remedies are placed on a continuum ranging from zero to infinitely high, or coercive, damages.

In the context of a multilateral trade agreement, such as the WTO, a combination of a rule of intra-contractual non-performance and the accompanying remedy procedure together establish a *trade policy flexibility instrument*. A trade flexibility tool is to be defined as any intra-contractual, legal provision that legitimizes *ex post* discretion in the form of a departure from performance as promised.[18] (Trade policy flexibility has also been termed "structured defection" (Rosendorff 2005), "selective disengagement" (Rodrik 1997, chapter 5), or "safety valve" in the literature).

Extra-contractual breach behavior and the subsequent punishment will be bundled together in the term *enforcement*. The WTO deals with issues of enforcement mainly in GATT/GATS Arts. XXIII and DSU Arts. 21 and 22, although some Agreements feature their own dispute settlement clauses (e.g. the Agreement on Safeguards and Countervailing Measures (SCM); or the Agreement on Agriculture (AoA)).

With these definitions of breach and remedies in place, we can now move on to a discussion of the tight interlinkage between mechanisms of escape and enforcement provisions, as well as that between the

[17] It should be noted that we use the words *punishment* and *sanction* in their customary contract-theoretical, objective, connotation. Neither term is part of the official WTO vocabulary. The DSU speaks of "suspension of concessions or other obligations," and "damages," or "trade effects," respectively. However, in WTO matters, the term *sanctions* has evolved into a colloquialism for the countermeasure of retaliation. This is not how we will use this expression.

[18] We use a broad notion of "trade policy flexibility." Our understanding of the term differs from some conventional definitions that depict trade policy flexibility as "the ability of governments to decide *unilaterally* when to introduce new *temporary import restrictions* after an international trade agreement has been concluded" (Roitinger 2004, p. 1, emphasis added). The difference is thus threefold: first, in this study, trade policy flexibility mechanisms are not reduced to liability rules, i.e. to those instruments assigning the discretion to injurers; secondly, we do not discriminate between temporary and permanent flexibility; thirdly, non-performance is not limited to ex post import restrictions, but more generally to all agreed-upon contractual behavior (e.g. retreat from a non-reciprocated obligation, such as a notification requirement).

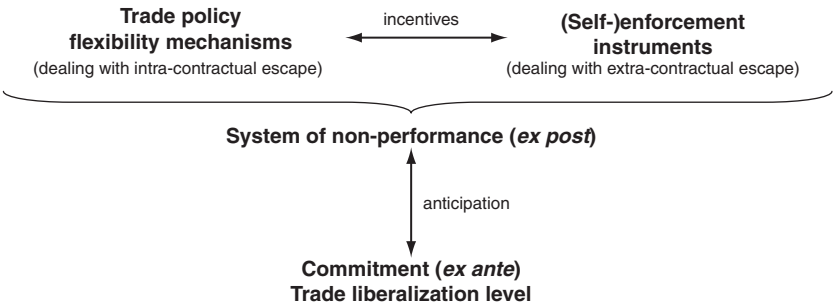

Figure 1.2 Commitment, breach, and trade policy flexibility in incomplete contracts
Note: This chart shows how trade policy flexibility mechanisms, enforcement instruments and *ex ante* trade liberalization commitments are linked in incomplete contracts: a proper enforcement scheme encourages shock-ridden signatories to use de iure flexibility mechanisms in situations of *ex post* regret. In anticipation of a functioning system of non-performance, all contracting parties are well-inclined to cooperate and thus are willing to undergo extensive up-front commitments. Whenever the system of trade policy flexibility of enforcement is defective, signatories can be assumed to cut down their pre-contractual concessions.

contractual system of non-performance and *ex ante* commitment. Figure 1.2 illustrates this interrelationship.

The intuition here is rather straightforward: the more incomplete a contract, the more important is the careful design of viable escape mechanisms (presuming functioning enforcement).[19] The availability and the quality of the negotiated flexibility mechanism(s) have an immediate impact on extra-contractual breach behavior of shock-affected parties (which we call "injurers" for shorthand). Whenever permissible intra-contractual behavior is mis-specified,[20] injurers under pressure may look for legal loopholes, and

[19] If, hypothetically, a contract were complete, that is, specified in detail all possible contingencies and prescribed comprehensive plans of actions, flexibility mechanisms would be superfluous. Every *ex post* non-performance would then by definition be extra-contractual, i.e. deviating, punishable behavior. Conversely, the more incomplete a contract, the more flexibility arrangements gain prominence.

[20] Escape clauses can be said to be mis-specified or ill-defined whenever they are too lax, too restrictive, or too ambiguous. Flexibility instruments are too rigid if they do not allow signatories to seize regret contingencies, are too expensive to enact, too restrictive in application scope, display ambiguous language, or fail to anticipate certain contingencies completely. They are too lax if they permit injurers to opt out inefficiently often, i.e. more frequently than a hypothetical complete contingent contract would permit. Ambiguous and ambivalent language result from poorly described contingencies and their outcomes.