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978-0-521-11997-9 - The Law, Economics and Politics of Retaliation in WTO Dispute Settlement

Edited by Chad P. Bown and Joost Pauwelyn

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Introduction

Trade retaliation in WTO dispute settlement: a multi-disciplinary analysis

CHAD P. BOWN AND JOOST PAUWELYN*

It is hard to think of a better topic for multi-disciplinary study than trade retaliation in the WTO. When a country violates WTO rules, the remedy of last resort is bilateral, state-to-state trade sanctions. Such trade sanctions are imposed against the violating country by one or more other WTO members who took the initiative to challenge the breach. WTO retaliation must, however, be multilaterally authorized by the WTO following, first, an elaborate procedure establishing (continued) breach in the first place and, second, an arbitration on whether the retaliation is 'equivalent' or 'appropriate' in the light of the harm caused by the original violation. This is where the law comes in: arbitrators must apply legal criteria to assess the harm caused by a WTO violation, select benchmarks and counterfactuals to do so, as well as decide, where requested, on whether the conditions for so-called cross-retaliation are met (that is, retaliation in the form of, for example, suspending intellectual property rights in response to a WTO-inconsistent import restriction). This process obviously involves economics as well, both economic theory (what is the role of *violation-cum-retaliation* in an incomplete contract?; what is the optimal design of remedies for breach of contract?) and applied or quantitative economics (how does one calculate lost trade, lost royalties or other economic harm caused by a WTO violation?; how does one make sure that the retaliation in response is 'equivalent?'). Finally, the design, implementation and effectiveness of WTO retaliation is deeply political, ranging from the decision of whether to retaliate in the first place

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(especially salient in developing countries) to selecting specific products to retaliate against (for example, with a view to compensate or protect domestic, import-competing industries at home, say, Mexico keeping out US corn syrup to please Mexican cane sugar producers; or, alternatively, to exert maximum political pressure in the violating country, say, the EC restricting Florida orange juice to affect US President Bush's re-election chances in 2004).

Given that GATT-authorized retaliation required consensus (including approval by the violating country itself!), retaliation under GATT (to be distinguished from unilateral retaliation under, for example, US section 301) was authorized only once from 1947 to 1995. Retaliation in the WTO, though subject to multilateral control, once found to be 'equivalent' or 'appropriate' is automatically authorized. This explains why in the 14 years since the establishment of the WTO, trade retaliation has been multilaterally approved no less than seventeen times in eight different trade disputes (one of which involved eight complainants, namely *Byrd Amendment*; in two other disputes, *EC-Bananas* and *EC-Hormones*, two complainants were authorized to retaliate). These disputes combined have spawned eleven arbitration reports (*EC-Bananas (US)*, *EC-Hormones (US)*, *EC-Hormones (Canada)*, *EC-Bananas (Ecuador)*, *Brazil-Aircraft*, *US-FSC*, *Canada-Aircraft II*, *US-1916 Act*, *US-Byrd Amendment*, *US-Gambling* and *US-Cotton Subsidies*).

With this critical mass of experience in the field, and given the multi-disciplinary character of the problem, the newly established multi-disciplinary Centre for Trade and Economic Integration at the Graduate Institute of International and Development Studies in Geneva, Switzerland convened a Workshop on 18–19 July 2008 entitled 'The Calculation and Design of Trade Sanctions in WTO Dispute Settlement'. This book is the outcome of that Workshop. It includes contributions from specialists in both trade law and economics. In addition, it narrates the practical experiences of most WTO members who were authorized to use trade retaliation from the perspective of diplomats or practising lawyers working for those countries.

Part I of the book offers an introductory background to the nature of WTO arbitrations on retaliation (Sacerdoti, Chapter 1) and the contested goal (or goals) that are set out, or can be expected to be achieved by trade retaliation based on both the history, text and context of the GATT/WTO treaty and the arbitration reports and country experiences and practices so far (Pauwelyn with comments by Jackson and Sykes, Chapter 2; Shaffer and Ganin, Chapter 3). Part II of the book summarizes and discusses the state of play after ten arbitration disputes on

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WTO retaliation from a legal perspective (Sebastian with comment by Lockhart, Chapter 4; Renouf, Chapter 5). Part III does the same from an economic perspective (Bown and Ruta with comment by Winters, Chapter 6; Evenett, Chapter 7).

Part IV examines the domestic politics and procedures for implementing WTO-authorized trade retaliation in individual countries, more specifically: the United States (Andersen and Blanchet, Chapter 8); the European Community (Ehring (Chapter 9) and Nordström (Chapter 10)); Canada (Khabayan, Chapter 11); Mexico (Huerta Goldman, Chapter 12); Brazil (Salles, Chapter 13); and Antigua and Barbuda (Mendel, Chapter 14). Part V looks at problems that have arisen in the practice so far, be they real or imagined, more specifically: problems faced by developing countries (Nottage, Chapter 15); problems resulting from the absence of compensation to individual economic operators (Sykes with comment by Mavroidis, Chapter 16); and problems and possible solutions related to timing, counterfactuals, causation and changed circumstances (Davey, Chapter 17). Schropp (with comment by Breuss, Chapter 20) offers a broader critique of the current arbitration practice based on a welfare analysis of WTO retaliation. Part V of the book also includes proposals for reform regarding the domestic decision-making process implementing trade retaliation (Malacrida, Chapter 18) and the role of the WTO Secretariat and interaction between lawyers and economists in WTO arbitrations (Bown with comment by Malacrida, Chapter 19).

Finally, Part VI of the book offers analyses of two new frontiers of WTO retaliation, namely retaliation taking the form of suspending intellectual property rights and retaliation in trade in services (Zdouc, Chapter 21; Abbott, Chapter 22; Appleton, Chapter 23). Part VI concludes with similarities and differences between, on the one hand, WTO retaliation and, on the other hand, compensation in investor–state arbitration (Kaufmann-Kohler, Chapter 24) and remedies in antitrust or competition law (Evenett, Chapter 25).

Rather than attempting to summarize the thirty-two contributions in this volume, this Introduction limits itself to pointing out three general lines of argument or critique that recur throughout the book. For ease of reference we refer to them as: (i) ‘trade retaliation is shooting yourself in the foot’; (ii) ‘trade retaliation simply does not work when developing countries win a case’; and (iii) ‘accurately calculating the authorized level of retaliation is a myth and close to impossible’. To avoid all doubt, we are not here agreeing with any of these statements. To the contrary, what we plan to do in this Introduction is to debunk them or, at least, to qualify them.

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**1 ‘Trade retaliation is shooting yourself
in the foot’ (reciprocity versus welfare; definition of
nullification; choice of counterfactual)**

The WTO remedy of last resort, that is, *restricting* trade, is, indeed, somewhat of a puzzle if one considers that the goal of the WTO is to *liberalize* trade. To authorize in response to a first trade restriction (the original violation) a second trade restriction (WTO retaliation) seems to assume that somehow ‘two wrongs’ (that is, twice reducing welfare) will make things ‘right’ again. Yet, as Winters points out, ‘[t]he exercise highlights an eternal dilemma that the WTO raises ... The institution is mercantilist through and through ... Reciprocity seems misconceived for most countries – I will stop hurting my economy [that is, I will comply with WTO rules] ... if you will stop hurting yours! Yet the GATT/WTO has harnessed reciprocity to preside over a massively welfare-increasing liberalisation of international trade’. Put differently, trade retaliation as a remedy against an illegal trade restriction may not make much economic sense (it is, in many cases, ‘shooting yourself in the foot’ and harms innocent bystanders). Yet, since the GATT/WTO is inherently based on a mercantilist game of ‘reciprocal exchanges of market access’, and this model has, in practice, offered us high degrees of trade liberalization, should we not accept this odd remedy of retaliation as part and parcel of the, after all, rather effective mercantilist game?

Brown and Ruta, in their assessment of the economics of permissible WTO retaliation, do follow this reciprocity model (based on the Bagwell and Staiger theory of trade agreements). For them, ‘[u]nder the reciprocity approach, the complainant is allowed to introduce a retaliatory policy measure ... i.e. a trade restrictive measure ... such that the value of export and import trade volumes between the two countries is stabilized’. In other words, in their view, the goal is that both the original violation and the retaliation have an equal effect on *volumes of trade*. Brown and Ruta subsequently apply this benchmark to original violations taking the form of tariffs, quotas, national treatment discrimination and subsidies, and find that in standard cases arbitrators have, indeed, followed the reciprocity model. Indeed, if retaliation is (i) engaged in by a ‘large country’ (in the terms-of-trade sense of being able to affect world prices) or even by a small country which can affect the world price of the products retaliated against (a country which thereby becomes ‘large’ for those specific imports), and (ii) calibrated at the level of a so-called ‘optimal tariff’ (most likely to be much lower than the standard 100 per cent duties currently

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imposed!), retaliation should *increase overall welfare* in the retaliating country (and, to that extent, *not* be ‘shooting yourself in the foot’, see Bown and Ruta as well as Nordström). Breuss’s empirical study referred to in this volume shows, for example, that in *US–FSC*, the EC retaliation (even combined with the original US violation) was actually slightly welfare increasing for the EC. What is more, in the WTO context, the traditional argument against ‘optimal tariffs’, that is, that they are likely to trigger retaliation, even a trade war, which in the end makes everyone worse off, is, at least under the law, no longer pertinent: WTO rules authorize retaliation against a continuing breach of WTO law; retaliation by the violator against such retaliation is *not* permitted.

In contrast, when it comes to WTO case law on retaliation in response to prohibited export subsidies (where retaliation is permitted up to the *entire amount of the subsidy*) Bown and Ruta are more critical, on the ground that the full subsidy amount ‘is not necessarily a good proxy for the size of the *trade effects* of the export subsidy – i.e., the volume of lost trade for the complainant’. On this very point, Sebastian, in his contribution on the law of permissible WTO retaliation, thinks along the same lines, arguing that in none of the arbitrations so far has the decision to take the *full amount of the subsidy* as a benchmark been adequately explained (in his words, ‘[t]he convoluted reasoning in *US–FSC* does not inspire any confidence’). As a result, Sebastian is of the view that ‘it is likely that arbitrators will come under some pressure in future cases to adopt uniform approaches across these provisions (notwithstanding differences in the wording used in the DSU and the SCM Agreement)’. Huerta Goldman, however, takes a polar opposite position: if retaliation is limited to only that share of trade represented by the complainant(s), instead of the full amount of subsidy or other violation, the violator is ‘better off to face retaliation ... than to comply with the WTO contract; a system which, under Huerta Goldman’s ‘chocolate cake scenario’, ‘significantly diminishes the effectiveness of retaliation and provides negative incentives for compliance and compensation’.

Returning to the GATT/WTO dilemma between ‘reciprocity’ and ‘welfare’ referred to by Winters, the contributions by Schropp and Breuss take a resolutely different approach as compared with the reciprocity model of Bown and Ruta. For Schropp, in what is essentially a welfare analysis, the goal of WTO retaliation is not reciprocity or rebalancing the scale of trade concessions and trade volumes, but rather ‘to compensate the Complainant for its true damage from the violation of the contract’. As a result, in Schropp’s view, WTO retaliation ought to be calculated not in

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order to stabilize the value of export and import trade volumes between the two countries (reciprocity), but 'based on a counterfactual that puts the injured party in as good a position as it had been if the violating party had performed as promised ("expectation damages")'.

Consequently, and this is hugely important, whereas under a reciprocity model (as in standard WTO arbitrations and Bown and Ruta) 'nullification or impairment' defined in Article 22.4 of the *Dispute Settlement Understanding* (DSU) amounts to the *trade effects* of the WTO-inconsistent measure on the complaining country, under a welfare model (Schropp and Breuss) 'nullification or impairment' amounts to the *net economic loss* caused by the WTO-inconsistent measure to the complaining country. It goes without saying that, in most cases, these two different starting points lead to very different dollar amount results. As Breuss puts it, 'equal trade effects will only coincidentally, if ever, proxy for equal welfare effects'.

The above debate among economists (reciprocity versus welfare) is, interestingly enough, also reflected in the contributions to this volume by lawyers. Sykes, for example, construes the goal and calculation of WTO retaliation as being aimed at broadly rebalancing the scales between the parties and essentially putting an *upper limit* on retaliation in order to 'facilitate arguably desirable deviations from the letter of the bargain under politically exigent circumstances'. Lockhart implies a reciprocity model when arguing that in the selection of 'metrics' to calculate the amount of authorized retaliation the 'punishment should fit the crime'. In his view, '[t]he crime scene here comprises the nature of the measure at issue and the nature of the obligation violated. Together, these two factors seem to influence the choice of metric'. In contrast, other lawyers contributing to this volume shift the focus from reciprocity between measures and/or trade effects, to compensation for harm caused (see, for example, Mavroidis and Davey, both arguing in favour of some form of compensation instead of, or in addition to, retaliation) and/or rule compliance (see, for example, Jackson and Shaffer and Ganin, for whom the core aim of WTO retaliation is not restoring reciprocity but 'inducing compliance'). On the assumption that compliance with WTO rules enhances overall welfare, this shift is somewhat analogous to a shift from a reciprocity model to a welfare analysis.

In sum, it is not that economists as a group focus on rebalancing or reciprocity and lawyers as another group favour rule compliance. Instead, in both disciplines the dilemma or tension between reciprocity and welfare can be detected. The practical consequences of these different approaches should not be underestimated. The debate has a direct impact

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on which benchmarks or counterfactuals ought to be chosen to calculate WTO retaliation. Reciprocity models tend to focus on trade volume effects. Welfare, compensation and rule compliance models tend to focus on net economic loss or the amount of the violation (for example, the full amount of the subsidy).

A similar tension prevails when it comes to the all-important choice of counterfactual (that is, in order to calculate trade effects or economic loss what hypothetical situation should the current situation be compared with?). One group of contributors to this volume (including Sebastian and Davey), as well as prevailing WTO arbitration practice, take as counterfactual the hypothetical, alternative situation where *the defendant would comply with WTO rules*. In *US–Gambling*, for example, this would be a US regime on Internet gambling that complies with the GATS (for example, full market access or, according to some, allowing foreign suppliers to compete in the horse-race gambling sector). Opting for the counterfactual of ‘rule compliance’ opens the difficult question of what to do in case different, alternative measures, with varying degrees of trade or economic impact, would comply with the WTO treaty? The arbitrators in *US–Gambling* adopted the criterion of a ‘plausible or reasonable compliance scenario’ without, however, ruling on whether the counterfactual eventually selected was, indeed, WTO-consistent. The arbitrators in *US–Gambling* found that this question of consistency fell outside the mandate of WTO arbitration on retaliation. This finding was strongly contested by a number of contributors to this volume (see, for example, Sebastian, Lockhart and Davey), all finding that a decision on the amount of authorized retaliation based on a counterfactual necessarily requires and allows finding that this counterfactual is, contrary to the original measure, consistent with WTO rules. As Sebastian puts it, ‘[i]t would appear that a threshold requirement for a counterfactual is that it is indisputably WTO-consistent’. Interestingly, Mendel, who is legal adviser to Antigua and Barbuda in the *US–Gambling* dispute, supports the arbitrators’ refusal to examine consistency on the ground that arbitration reports on retaliation cannot be appealed to the Appellate Body and, hence, should not decide on questions of substantive WTO compliance. Ehring, along similar lines, argues that ‘the question of legality of a counterfactual is often not suitable for a reliable resolution within a sanctions arbitration’.

Another group of contributors to this volume does not opt for the counterfactual of ‘what would be the situation if the defending country were to comply with WTO rules’ (that is, what would the situation be ‘*but for the violation*’). Instead, they advocate the counterfactual of, as

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Ehring puts it, ‘the hypothetical situation where the illegal market access restriction does not exist’ (that is, what would be the situation ‘*but for the trade restriction*’, an approach that was followed in *EC–Hormones*). In *US–Gambling* this counterfactual would have led to a much bigger award as it would have assessed the impact on Antigua of the US ban on online gambling *tout court*, as opposed to only the impact of the discriminatory US ban on online horse-racing bets. This ‘but for the trade restriction’ counterfactual is not only supported by Ehring and (not surprisingly) Mendel, but also in Schropp’s welfare analysis of trade retaliation. Similarly to Ehring, Schropp advocates the counterfactual of a ‘hypothetical situation that would exist if the illegality had never been committed and the injurer had always performed according to the contract (*expectation* measure)’. With such expectation damages, ‘the victim of a contractual violation is fully compensated for all its efficiency losses due to the Respondent’s measure in question’. Whether WTO retaliation must be calculated to offset the effects of WTO *violation* (as in *US–Gambling* and most other arbitrations) or of the *trade restriction as such* (as in *EC–Hormones*) is certain to remain an important element of debate in the future.

In conclusion, there is no doubt that in many cases trade retaliation (especially at the level of 100 per cent duties) has, or would, end up with the country ‘shooting itself in the foot’ (unless the two conditions set out above for welfare-enhancing retaliation are met, that is, being a ‘large country’ and setting the tariff at the right or optimal level). However, within the mercantilist reciprocity model of the GATT/WTO this should not come as too much of a surprise. Similarly, WTO retaliation can be criticized for not compensating the actual victims of a trade violation, even for causing additional harm to innocent bystanders. Yet, if one views WTO retaliation as a sanction to induce compliance it is hardly surprising that trade retaliation is also costly to the one imposing it (imprisonment costs money to the state). As Pauwelyn puts it ‘[w]ithout fixing this goal or benchmark [of WTO retaliation], any debate on effectiveness of the system is meaningless, with some authors saying that WTO remedies are “too weak”, others saying that they are “too strong” and yet others concluding that they are “about right”’. In contrast to the WTO regime, the goal of damages in investor–state arbitration is clear. As Kaufmann-Kohler writes, ‘there is no doubt that the primary purpose of the remedies provided by investment law is to compensate an investor for the losses caused by an act of a State’. Similarly, in antitrust or competition law, Evenett illustrates that one of the core goals of fines, even imprisonment,

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is to punish and deter violators. Returning to the WTO regime, Pauwelyn concludes that although full compensation of all victims or outright punishment cannot realistically be met with the current purely prospective ‘equivalent retaliation’ instrument, WTO retaliation does serve variable, overlapping goals which at times creates confusion. Yet, in Pauwelyn’s view, ‘different types of legal entitlements should be matched with different types of protection and enforcement goals (referred to as liability rules, property rules and inalienability)’.

2 ‘Trade retaliation simply does not work when developing countries win a case’ (informal remedies; the WTO enforcement club; smart sanctions; cross-retaliation)

Besides the one-liner that ‘trade retaliation is shooting yourself in the foot’, another idea or critique that is often voiced in discussions on WTO retaliation is that ‘trade retaliation simply does not work when developing countries win a case’. What impact can, for example, trade sanctions by Antigua have on the United States? In other words, what to do when faced with what Mendel refers to as ‘[m]assive inequalities between two economic and political systems’?

Nottage, working as a trade lawyer for the Advisory Centre on WTO Law whose task it is to assist developing countries, critically evaluates whether weaknesses in WTO retaliation rules undermine the utility of WTO dispute settlement for developing countries. His answer is negative and reached by distinguishing between what he calls ‘theory’ and ‘practice’. Nottage agrees with ‘the theoretical proposition that WTO retaliation rules are skewed against developing countries as a means of inducing compliance by WTO Members of asymmetrical market size’. At the same time, however, Nottage disagrees with ‘the consequential argument that shortcomings in WTO retaliation rules undermine the utility of the WTO dispute settlement system for developing countries’. The core reason for his conclusion is that ‘GATT and WTO dispute settlement *practice* demonstrates high rates of compliance with adverse dispute settlement rulings *even when smaller and developing countries are complainants*’ (emphasis in the original). As a logical matter, Nottage argues, it must, therefore, be true that ‘the capacity to retaliate effectively is often not a significant factor for government compliance with adverse panel and Appellate Body rulings’. Pawley similarly refers to the informal remedies of reputation and ‘community’ costs as major driving forces behind WTO compliance.

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Of the so far seventeen authorizations to retaliate, eight were granted to developing countries and only in one instance did a developing country actually implement the retaliation (Mexico against the United States in *Byrd Amendment*). One explanation, Nottage suggests, is that in the seven other cases 'actual retaliation may no longer have been necessary or of limited incremental purpose' (he refers, for example, to US retaliation in *EC-Bananas* and a pending settlement with the EU as possible reasons for why Ecuador did not implement retaliation in *EC-Bananas*). The *threat* or *authorization* to impose sanctions may, therefore, mean as much as (if not more than) actually imposing sanctions. Or as Khabayan puts it when talking about Canada's retaliation against the United States in *Byrd Amendment*: 'the product targets [live swine, ornamental fish, oysters and cigarettes, selected because the supporters of the offending legislation were from Virginia and Maine] appear to have more to do with sending a political message to the US Congress rather than having a real economic impact. But the political message was underscored by the fact that several of the co-complainants in this case sought retaliation authorization nearly concurrently'.

In sum, Nottage concludes that '[d]eveloping countries should not be overly dissuaded from using WTO dispute settlement to achieve their trade objectives due to a lack of retaliation capacity'. Huerta Goldman, working for the Mexican mission to the WTO in Geneva, puts it somewhat differently: 'Retaliation as a legal remedy is not very effective. But it is much preferable to have a system which offers these mechanisms, as deficient as they may be, than not to have any such system at all.'

Evenett's economic analysis ('Sticking to the rules') confirms Nottage's conclusion from a different perspective. Evenett uses data on international trade flows to estimate the potential impact of trade sanctions (or the threat thereof) in the bilateral relationships of twenty-two countries (twenty major developing countries, Japan and the United States). By gauging the possible impact of trade sanctions Evenett hopes to find a proxy of the varying incentives for countries to stick to WTO rules. Evenett agrees that a country's capacity to enforce WTO rules, that is, to protect market access negotiated under the WTO, does, of course, depend on the size of its market. Yet, he also finds that sanctioning capacity does *not* depend on a country's level of development (market size matters as much for Switzerland as it does for Costa Rica or Antigua). Crucially, Evenett further explains that the impact of trade sanctions not only depends on the market size of the *retaliating country*, but also on the amount and distribution of exports, and the types of products exported, by the *violating country*. Trade sanctions will, for example, work better against a country that exports a lot, and mainly parts and components (or what Evenett refers to as 'actionable