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The Case for Tariff Compensation in WTO Dispute Settlement

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There is nearly unanimous consent among WTO practitioners and scholars that the remedy of tariff compensation is legally superior, economically more efficient and socially more beneficial than retaliatory suspension of tariff concessions (tariff retaliation). This article argues in favour of a revitalization of tariff compensation. However, under the current regime compensation is a thoroughly unattractive policy instrument for decision makers having to temporarily opt out of a WTO Agreement in reaction to domestic shocks. Hence, tariff compensation is vastly underused. We examine reasons for the relative unattractiveness of this policy instrument and propose a substantial reform agenda of the WTO agreements and the dispute settlement system, so as to make compensation a policy tool of choice for trade policymakers. Most importantly, we suggest breaking with the presumption of legal and calculative equivalence of tariff compensation on the one hand and retaliatory suspension of concessions on the other. Making use of the fact that the true scope of nullification and impairment awards has never been legally exhausted in WTO arbitration, we suggest that by deliberately discriminating between the amount of compensation and that of retaliation, policymakers in violation of WTO Agreements can be induced to choose offering compensation to the injured party – an outcome that is economically and socially superior to embracing tariff retaliation.

Keywords: WTO Dispute Settlement, Political Economy, Trade Sanctions, Antidumping, Safeguards.

JEL Codes: F02, F13, K33.

*“Consult before you legislate
Negotiate before you litigate
Compensate before you retaliate
And comply – at any rate.”*

PASCAL LAMY
(then EU Commissioner for Trade)
“Hymn to Compliance”.¹

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¹ Cited in CHARNOVITZ (2001, fn. 18)

1 Introduction

In this paper we are concerned with systemic issues of the enforcement mechanisms pursuant a trade dispute in the WTO, with flaws of the Organization's dispute settlement body (DSB), and with avenues of institutional reform.² More precisely, we are examining the relationship between and hierarchy of the two core DSB enforcement tools (termed "remedies", "countermeasures" or "punishments"³) at hand, namely tariff compensation and retaliatory suspension of tariff concessions (retaliation). Our aim is to encourage use and application of tariff compensation as the remedy of choice for policymakers.

In the recent past there have been some propositions by policymakers, lawyers and economists to stimulate the use of tariff compensation in the realm of the WTO. Most prominently, LAWRENCE (2003) brought forth the idea of multilaterally negotiated compensation commitment schedules, where WTO Members pre-commit to liberalizing certain sectors should they lose a trade dispute. Others have pondered about making compensation mandatory and automatic,⁴ or replacing tariff compensation with monetary fees.⁵ While these proposals to establish compensation as the enforcement mechanism of choice are laudable, we submit that we find the efforts wanting in at least one fundamental aspect: The authors tend to look at the issue of compensation in isolation. That is, proposals do not address the question of how to make compensation more attractive to trade-policymakers. Alternatively, some proposals maintain that by dictating a certain compensatory response, policymakers will oblige instantaneously. To our mind, the isolated look at the remedy of compensation is profoundly myopic. We contend that any proposal aiming to bolster tariff compensation is largely futile as long as we don't know just why compensation is so unattractive to policymakers and what the exist-

2 DSB enforcement mechanisms are understood here as both the implementation procedure after a panel or Appellate Body ruling, as well as the nature of legal remedies.

3 To avoid confusion, we shall stick to the nomenclature of 'remedies', since this is the term used in cases of State Responsibility under public international law (cf. MAVROIDIS 2000, GRANÉ 2001).

4 Injuring members are suggested to be legally obliged to offer compensatory tariff liberalization to the injured party. Some proposals suggest strong penalties for non-compliance, such as getting disenfranchised or seeing fundamental member rights suspended (critical of those suggestions: CHARNOVITZ 2001, p. 827 or LAWRENCE 2003, p. 81).

5 Propositions to revitalize compensation by making it automatic and mandatory come from the Meltzer Commission to the US Congress (see "International Financial Institutions Advisory Commission Report: March 2000), the government of Mexico (WTO Doc. TN/DS/W/23 and /40), LINDSEY et al. (1999), ROITINGER (2004, p. 188), CHARNOVITZ (2001 and 2002b) and others. Proposals to design compensation as monetary fines can be found in PAUWELYN (2000, p. 345), BARFIELD (2001, p. 131), the SUTHERLAND COMMISSION (WTO 2004, chapter VI/D), or BRONCKERS/VAN DEN BROEK (2005, p. 109).

ing (and apparently more attractive) alternatives are. Standard welfare-economics may tell us that the enactment of tariff compensation is by far more desirable than the remedy of retaliation. However, the revitalization of tariff compensation as the remedy of choice cannot be achieved by indulging into normative assertions on the conceptual welfarist superiority of this remedy over retaliation. We need to understand the reasons why tariff compensation is hardly ever offered by the losing party of a trade dispute and which political and economic factors induce recalcitrant offenders to instead favor embracing retaliatory measures against their own exporters.⁶ Therefore we will shift our view away from normative overtones (that merely assert what the "first-best" WTO enforcement mechanism ought to look like). Instead, we will take an under-researched route and conduct a positive analysis of WTO dispute settlement as it stands today, in order to come up with systemically viable reform proposals. It seems clear to us that every reform proposal must consist of (i) strategies to discourage inefficient and unfair alternatives to tariff compensation, while at the same time (ii) making it more attractive to policymakers to offer compensation in return for damage inflicted on trade partners.

Chapter 2 will introduce the legal procedures of enforcement as they are laid down in the DSU. Although we submit there that there is a strong legal and economic case to be made in favor of tariff compensation as the preferred WTO remedy, the reality of enforcement exactly counters those normative precepts: Contemporary WTO practice is severely biased in favor of retaliation. In chapter 3 we take a political-economic stance in order to assess why the factual realities of WTO enforcement are so strikingly skewed against compensation and what makes it such a vastly underused policy instrument. We examine the decision space of policymakers in the violating country, who time and again feel compelled to react to domestic protectionist shocks or economic emergencies. We show that protectionist policymakers have a menu of escape mechanisms at their disposal and that the availability of opportunistic policy tools, such as antidumping or countervailing duty measures, frustrates the proper use of tariff compensation as the first-choice remedy. Our reform agenda (chapter 4) proposes to first frustrate the opportunistic and protectionist use of antidumping and countervailing duty codes, and to strengthen the

6 Our discussion thereby closely resembles the normative debate about tariffs, quotas and subsidies in international economics: It is known that border measures and red-tape instruments are economically detrimental in the overwhelming majority of cases, yet hardly anyone has come up with feasible solutions against protectionist trade policies ...

policy tool of (compensatory) safeguard action. Second, we strive to give compensation an equal procedural footing by integrating compensation negotiations into the official arbitration procedure of Art. 22 DSU. Third, we suggest a re-evaluation of the presumed calculative equivalence of tariff compensation and retaliation. In particular, we pledge for the introduction of a quantitative wedge between compensation and retaliation awards. This amounts to a deliberate calculative bias by DSB arbitral panels in favor of compensation awards, and against retaliatory tariff hikes. This, we contend, is within the legal bounds of the DSU. Through these three measures we believe it to be possible to induce policymakers in countries “escaping” their obligation to comply with the panel verdict to prefer offering tariff compensation over embracing retaliation. This reform proposal can potentially lead to an outcome that is economically and socially superior to the predominant enforcement tool of tariff retaliation without having to make compensation mandatory (a reform that would be politically infeasible) and without proposing a change in the inherent systemic logic of WTO enforcement.

2 Theory and practice of remedies in the WTO

In this chapter we briefly look at the legal procedures of enforcement in the WTO (Art. 22 DSU). The DSU unambiguously states that a situation in which the convicted defendant offers tariff compensation is preferred to its embracing retaliation (Art. 3.7 DSU). This exigency is rooted in basic welfare-economic considerations: Plainly, voluntary compensation offers are economically vastly superior to the enactment of retaliatory tariffs. However, we will show that the reality of contemporary WTO practice belies this asserted hierarchy of remedies, and that tariff compensation is placed at a striking disadvantage – both procedurally and structurally.

2.1 Compensation and suspension of concessions in the DSU

Article 22 of the DSU lays down the enforcement procedures of a trade dispute pursuant to unrelenting non-compliance by the defendant Member with a panel or Appellate Body (AB) ruling.⁷ *De facto*, the defendant now has two options:⁸ It can either re-enter into negotiations with the injured state in order to negotiate a “a mutually acceptable compensation” commensurate to the amount of trade damage inflicted on the com-

plainant(s), as Art. 22.2 DSU stipulates. Alternatively, the violating party can decide to endure retaliation. The remedy of retaliation (also known as “sanction”) provides the complainant with “the possibility of suspending the application of concessions or other obligations under the covered agreements on a discriminatory basis vis-à-vis the other Member, subject to authorization by the DSB of such measures.” (Art. 3.7). That means, a winning plaintiff can enact unilateral tariff increases against some of the non-compliant Member’s export sectors. Before an injured party can bring into place its unilateral tariff hikes, however, it has to notify an “authorization request” to the DSB indicating its intended retaliation schedule (Art. 22.2 and 22.3 DSU; the retaliation schedule specifies the complaining party’s request for retaliation: the mix of target industries, the nature of retaliation and total retaliation amount). This enforcement schedule has to be in accord with basic principles and procedures of retaliation (laid out in Art. 22.3 DSU) and can be contested by the defendant country. If the retaliation schedule is challenged (which is most often the case), an arbitration panel (Art. 22.6 and 22.7 DSU) will set the quantitative amount and the mix of sectors of the defendant’s retaliation awards.

Both “compensation and retaliation are temporary solutions only, and are merely instruments to ‘restore the balance of concessions’ with compliance as the ultimate objective.” (BRONCKERS/VAN DEN BROEK 2005, p. 102; see also JACKSON 2004, p. 109; JACKSON 1997, p. 60).

This re-establishment of the balance of trade concessions (also known as “rebalancing” or “reciprocity”⁹) is a largely abstract concept. Ideally,

7 Art. 22 comes into play if all possibilities of mutual settlement are exhausted (Art. 4 and 5 DSU), after the lapse of the “reasonable period of time” (that Art. 21.3 DSU grants), and after the compliance panel (Art. 21.5 DSU) has established that possible measures taken by the defendant were inadequate. In short, Art. 22 DSU strikes if the defendant stays recalcitrant and decides not to comply with its primary obligation ‘to bring the deviating measure into conformity with the WTO Agreements’: as Art. 19 DSU posits.

8 The disclaimer *de facto* is in order here, because the DSU is ambiguous about the legal nature of panel recommendations. It is not clear whether or not a condemned defendant is under an international-law obligation to comply with the panel or AB recommendation, which usually advises the defendant to withdraw the illegal measure in place. A lively academic debate has spun around this question with JACKSON (1997, 2004); CHARNOVITZ (2002a); PAULWELYN (2000) in favor of the legal obligation to comply. SYKES (1991, 2001); BELLO (1996); SCHWARTZ/SYKES (2002) or ALEXANDROV/PALMETER (2002), on the other hand, bring forth an ‘efficient breach’ hypothesis that necessarily requires a legal option for defendants whether to comply with panel recommendations or whether to compensate instead.

9 For a legal explanation of rebalancing, cf. (DAM 1970, p. 357); (CHARNOVITZ 2001, p. 801); (CHARNOVITZ 2002a, p. 414). For an interpretation of the economic principles of ‘rebalancing’ and ‘reciprocity’ in dispute settlement, cf. (LAWRENCE 2003, p. 19); (BAGWELL/STAIGER 2002 pp. 58, 104); (ETHER 2001, p.3); (ROSENDORF 2005, p. 390) or (BOWEN 2002 p. 288).

WTO remedies are to restore the *status quo ante* the breach.¹⁰ Hence, we observe (in theory) a clear presumption of quantitative equivalence of tariff compensation and retaliatory suspension of concessions. Both remedies ought to be equal to total damages suffered by the injured party.¹¹ Compensation, however, in contrast to retaliation is voluntary (Art. 22.2 DSU) and consequently not an automatic obligation of the responsible state in breach of one of the WTO agreements.

By and large, remedy awards have largely been future-oriented (prospective) and hence do not compensate the injured party for any damage suffered in the period between commencement of the breach and the adoption of the panel report. If they did, we would call this retrospective damages. Note that the prospective nature of WTO remedies is not put down *expressis verbis* in any WTO provision, but so far only manifested itself in coherent WTO jurisprudence.¹²

It is crucial to note (and will have bearing on our argumentation *infra*) that the theoretical ideal of WTO reparations as rebalancing the mutual

10 The prerequisite that remedies re-establish the *status quo ante* the breach by bringing the balance of mutual concessions in order, bears two important consequences: First, suspension of concessions must never take on a punitive nature (MAVROIDIS 2000, p. 800); (HUDEC 2002, p. 86); BELLO (1996), from a legal perspective: SCHWARTZ/SYKES (2002, at fn 26); (LAWRENCE 2003, p.33); BAGWELL/STAIGER (2002, chapter 4) and ETHIER (2002) for economic justification. Second, the calculatory benchmark for achieving re-balancing are so-called 'expectation damages'. (SCHWARTZ and SYKES 2002, p. 180) define expectation damages as the 'sum that places the promisee in as good a position as it would have been if the promisor had performed.' Especially noteworthy is that expectation damages are not satisfied by a mere calculation of actual, direct trade damages (which are estimated as price increase/decrease due to the tariff measure times import/export losses times import/export substitution elasticity). Rather, expectation damages must be interpreted so as to embrace all further efficiency costs (opportunity losses or losses in domestic value-added, cf. (MAVROIDIS 2000, p.800)) caused by the partial breach of the agreement over and above direct trade effects. Those efficiency losses include the present (discounted) values of profits foregone, lost scale economies, costs of finding new markets/partners, switching-costs in production, possible "second-order effects" of retaliation (retaliation depreciates the initially agreed-upon mutual balance of market access and leads to two-way trade on a lower, hence suboptimal level; cf. (CHARNOVITZ 2002a, p. 418)) and so forth.

11 We find ample evidence in the WTO Agreements in support of the presumption of equivalence of tariff compensation and retaliation: As (Lawrence 2003, p. 19); (Bagwell/Staiger (2002, pp. 6, 58); (Bown 2002 p. 288) or (Sykes 2001, p. 353) accurately point out, the rebalancing feature of compensation systemically cuts across the entire GATT and GATS Agreements. For example, we find evidences thereof in Articles XIX (safeguards) and XXVIII (tariff renegotiations) of the GATT, as well as in Articles 3.7 and 22 of the DSU. Throughout the agreements compensation is mandated to be 'substantially equivalent' to the damage done (see e.g. GATT Art. XXVIII.2 and XIX.2). The alternative to offering compensation (in case of disagreement over its amount and scope) unambiguously and at all times is the remedy of retaliation, i.e. the suspension of concessions equivalent to the level of nullification and impairment (e.g. in Arts. XIX.3(a) or XXVIII.3(a),(b) GATT and notably 22.4 DSU). Therefore it is of the same amount as compensation.

12 (BRONCKERS/VAN DEN BROEK 2005, p. 103) or (GRANÉ 2001, p. 768) claim that the prospective nature of WTO remedies is justified by virtue of Article 19.1 DSU. (MAVROIDIS 2000, p. 789), however, does not detect any constraint on retroactive remedies in the DSU.

tariff concessions of trade disputants has largely been a fiction. In other words the *status quo ante* the breach of a WTO Agreement has never been achieved properly. Thus, dispute settlement awards have never really placed the injured party in a position anywhere close to where it was before the breach (CHARNOVITZ 2002a at fn. 13). This is so, firstly, because retaliatory suspensions of concessions that have been authorized by DSB arbitrators have repeatedly interpreted "level of nullification and impairment" to be tantamount to direct trade damages, i.e. the effective trade losses (MAVROIDIS 2000, p. 774; HUDEC 2002, p. 86; LAWRENCE 2003, p. 37; WTO 2004, § 243; CHARNOVITZ 2002a, p. 418). In other words, efficiency losses (see footnote 10) always went at the expense and to the detriment of the complaining party. Secondly, retaliation awards under the DSU jurisdiction have hardly ever been granted retrospectively.¹³

2.2 Conceptual considerations: The legal superiority of tariff compensation as the remedy of choice and its normative welfare-economic justification.

Article 3.7 DSU unequivocally provides for a formal ranking of the remedies available under the WTO dispute settlement system.¹⁴ If we couple the language of this article with the legal principle of effective interpretation (or *effet utile*¹⁵), we detect a clear and unambiguous legal hierarchy of

13 In total there were five panels that departed from the standard prospective remedy (all of them dealing with antidumping and countervailing duties [CvD]), that recommended revocation and reimbursement of illegally imposed duties, see (MAVROIDIS 2000, pp. 775) and (LAWRENCE 2003, chapter 3). Note that disputes in subsidy and CvD matters are not regulated by the DSU, but by special procedures in a separate Agreement (Arts. 4 and 7 of the Agreement on Subsidies and Countervailing Measures). In the recent WTO past, Brazil – Aircraft, Canada – Aircraft, and US – FSC (all subsidy cases) applied retroactivity. In Canada – Aircraft, e.g., the arbitral panel awarded Brazil with retaliation rights that were 20% in excess of the actual subsidies that had previously been paid to aircraft producers. Therewith, the arbitrators not only made use of retroactivity (previous illegal subsidies had to be repaid), but also allowed for efficiency losses over and above the direct trade damage – the sum of subsidies paid.

14 Art. 3.7 DSU reads in pertinent parts (emphases added): The aim of the dispute settlement mechanism is to secure a positive solution to a dispute. A solution mutually acceptable to the parties to a dispute and consistent with the covered agreements is clearly to be preferred. In the absence of a mutually agreed solution, the *first objective* of the dispute settlement mechanism is usually to secure the withdrawal of the measures concerned [...]. The provision of compensation should be resorted to only if the immediate withdrawal of the measure is impracticable and as a temporary measure pending the withdrawal of the measure which is inconsistent with a covered agreement. The last resort which this Understanding provides to the Member invoking the dispute settlement procedures is the possibility of suspending the application of concessions or other obligations under the covered agreements on a discriminatory basis vis-à-vis the other Member, subject to authorization by the DSB of such measures."

15 The principle of *effet utile* mandates that all terms of a treaty are presumed to be necessary for its interpretation and that every single provision must be interpreted in an effective way and still leave a function to the other provisions.

tariff compensation over retaliatory suspension of concessions.¹⁶ It is not hard to fathom why Art. 3.7 DSU features such a clear and unequivocal language, since there is a clear normative welfare-economic case to be made in favor of tariff compensation. We now briefly lay out a line of argumentation that is largely uncontested, yet inconsequential. In chapter 3 we shall demonstrate why this is so.

Tariff retaliation can display some conceptual advantages: It is the *ultima ratio* in WTO enforcement since it is self-executable by the injured party itself. This self-enforcement property, the “power of economic suasion” (CHARNOVITZ 2002a, p.421, quoting JAMES BACCHUS, a former AB judge), arguably makes retaliation a strong deterrent against breaches of the WTO agreements and induces compliance in member states (e.g. BOWN 2004, p. 812; CHARNOVITZ 2002a, p. 414; LAWRENCE 2003, p. 80). However, the remedy of retaliation displays a series of palpable and well-documented economic drawbacks: (i) it is severely biased against small countries and hence inherently unfair; (ii) it is economically nonsensical; and (iii) it frustrates the spirit and purpose of the WTO as a whole. We now elaborate shortly on each systemic drawback of the retaliation regime.¹⁷

Retaliation is severely biased against small countries: The threat of retaliation is dependant on the relative economic power of the party adopting it. Retaliation is only likely to be effective in a setting where a large, powerful country is retaliating against a small economy, and where the two countries are in a brisk trading relation. This places small and economically insignificant players at an immense disadvantage and makes the system of retaliation inherently unfair.¹⁸ First, small economies just cannot cause economic hardship to a large industrial country or its producers by raising their home tariffs vis-à-vis the perpetrator’s exports. Second, economically insignificant countries that are unable to improve on their terms of trade through a border measure, simply “shoot them-

16 The facts that compensation and retaliation are (presumably) just calculatively equivalent, and that compensation currently plays a minor role vis-à-vis retaliation, do not invalidate the precedence of tariff compensation as the remedy of choice. Rather, as we will show later, they are merely evidence for a practice that is *de facto* frustrating any realistic interpretation of compensation while *de iure* lacking any express support within WTO terminology.

17 An aggravating factor that we will not discuss much further in this section is that the prospect of facing retaliation will oftentimes fail to achieve effective deterrence of scofflaw members. The main reason for that, of course, is that for them the fallback option of facing retaliation is never worse (in fact often more beneficial) than any other remedial measure in the DSU! Or, as MAVROIDIS (2000) at p. 807 puts it: “If, at worst, violating the WTO can lead to countermeasures that are no greater than the violation, how do these measures achieve compliance?” (emphasis added).

18 For support of this argument, cf. also DIEGO-FERNANDEZ (2004); (LAWRENCE 2003, p.4); (BRONCKERS/VAN DEN BROEK 2005, p. 103); (PAUWELYN 2000, pp. 338), and CHARNOVITZ (2001, pp. 814).

selves in the foot” (MAVROIDIS 2000, p. 807) when retaliating. Through raising border tariffs they would add insult to injury: When retaliating, small countries would thus incur domestic welfare losses in addition to the WTO violation inflicted upon them by the powerful country in the first place. It does not come as a big surprise, then, that various small-country winning plaintiffs did choose not to exercise their right of retaliation against big countries at all, such as in the cases US – High-Fructose Corn Syrup or in EC – Bananas (where the plaintiff governments Guatemala, Honduras, and Mexico took no further action after winning the case; CHARNOVITZ 2002a, p. 413; cf. also LAWRENCE 2003, p. 7). Needless to say, this placed the perpetrating countries in a comfortable (viz. non-deterred!) situation.

Retaliation is economic nonsense: From a normative welfare-economic standpoint retaliation in form of raising tariffs over and above the economically optimal tariff (for large countries) is largely economically nonsensical and counterproductive.¹⁹ Retaliatory tariff hikes harm downstream industries, importers, and especially consumers (who, note, are all uninvolved in the case at hand²⁰); higher tariff barriers are tantamount to blatant protectionism and thus economically inefficient. Moreover, the mere possibility to enact retaliation creates severe protectionist pressures in the sender countries and produces complacency among protected domestic industries if this right is exercised. Once retaliatory tariffs are granted they will reduce the incentive to restructure in the protected sectors.

Tariff retaliation runs profoundly counter to the spirit of WTO: It is evident that the regime of “casting out the demons by the ruler of the demons” is a dubitable strategy.²¹ The WTO sets out to promote free trade and continuous liberalization. Retaliation, now, reduces world trade instead of liberalizing it; and it produces unmeasured and therefore largely

19 The arbitration panel in EC – Bananas disclosed that it had encouraged the two dispute parties to negotiate, since “the suspension of concessions is not in the economic interest of either of them” (WTO Doc. WT/DS27/ARB at § 2.13).

20 The fact that uninvolved parties are harmed by the act of retaliation, some have argued, e.g. (PAULWELYN 2000, p. 341); (CHARNOVITZ 2001, p. 811); (CHARNOVITZ 2002a, p. 419), can be interpreted as an effective depreciation of basic rights of individuals. Through retaliation actions economic agents in exporting countries are being barred from their right to economic activity. This form of collective punishment is highly questionable from a legal (let alone a moral) standpoint.

21 As the Sutherland Report recently put it aptly (WTO 2004 at §240): “The problem is that retaliation goes against the underlying objective of the WTO generally to promote rather than restrict international trade”.

unknown economic hardship on uninvolved third parties.²² Tariff hikes, understood as “sanctions” also foster an atmosphere of rivalry and mistrust: Retaliating countries try to inflict maximum harm on the violating Member, for example by means of “carousel retaliation” (cf. HUDEC 2002, p. 88), or by strategic retaliation against politically sensitive areas of the target country.

If we juxtapose the alternative remedy of tariff compensation to the measure of retaliation, it is easy to see why the sympathies of economists are with the former. Compensation has a liberalizing impact, and is hence globally welfare-enhancing. It is fully in line with the spirit of the WTO. It bears large global spillovers, since it is granted on an MFN basis (it is “MFNed”). Compensation is fair towards small players: A big-country violator must liberalize certain sectors (a measure that can be domestically painful as we will show later), which is to the unambiguous benefit of the small-country complainant. By hurting the policymakers of the injuring country, compensation is prone to induce compliance even in economically powerful countries. On a micro-level, tariff compensation fosters competitive and innovative pressure worldwide and induces industry restructuring in liberalized sectors. Clearly, lower tariffs benefit consumers, foreign exporters, and using industries alike.

2.3 The reality of WTO enforcement: The predominance of retaliation over tariff compensation

The previous subchapter has documented a clear legal and normative preference of tariff compensation over its alternative remedy of retaliation. However, the reality of WTO enforcement paints a different picture: As things stand today, tariff compensation is at a striking disadvantage vis-à-vis retaliation: Until May 2005 there have been nine instances of non-compliance, where official arbitrations over the total sum of retaliation awards under Article 22.6 DSU occurred.²³ Tariff compensation, in con-

22 An example for third-party externalities through unilateral retaliation are losses incurred to foreign suppliers. Suppose the EU instituted a 100% tariff on U.S. automobiles in retaliation for the FSC case. Korean steel producers supplying the Big Three car manufacturers in Detroit might lose out. And so might Korean carmakers, if the Big Three dumped their excess production (originally meant for the EU market) on the (non-EU) world market (for another example, cf. CHARNOVITZ 2002a, p. 419).

23 EC – Hormones (I&II); EC – Bananas (I&II); Brazil – Aircraft; US – FSC; Canada – Aircraft; US – Anti-Dumping Act of 1916; US – FSC (data available from the WTO website).

trast, has only occurred once (Japan – Alcoholic beverages²⁴). Tariff compensation is also a crucial component when enacting safeguards (Art. XIX GATT and Agreement on Safeguards). However, as ROITINGER (2004) shows, an overwhelming majority of Members invoking definite safeguard measures have chosen to refrain from granting compensation the injured parties, thereby risking the initiation of an official dispute (and possible retaliation) by the victims instead.²⁵

But why have member states clearly favored risking retaliatory suspension of concessions over compensation offers? Apart from political-economic reasons (which we will address in the next chapter), there are clear procedural and structural disadvantages connected with granting compensation. First, the instrument of tariff compensation is at a significant procedural disadvantage: Whereas the official process for retaliatory suspension of concessions is spelled out meticulously in Art. 22.3-9 DSU (including the inception of an “arbitration panel” with an official arbitrator, special time frame, and precise procedures), tariff compensation does not benefit from any structured, mediated practice. Second, the DSU has been generous in determining a “reasonable period of time” (RPT) to allow for compliance to occur.²⁶ Since retaliation is usually granted prospectively this period of time regularly gives non-complying violators a time-premium, i.e. a period in which they can continue violating the Agreement – for free. Compensation on the other hand, is to happen anywhere between the initiation of the dispute and the expiry of the RPT (Art. 22.2 DSU). Conceptually, it is to be offered immediately after the panel report is adopted. Hence, the defendant state is unlikely to make recourse to tariff compensation even if it actually intends to eventually bring the measure into conformity. A third issue which limits the recourse of violating Members to compensation is its requirement to provide tariff liberalization to all Members on a “most favored nation” (MFN) basis (more on that below). Fourth, as we pointed out before, there is a presumption of calculatory equivalence between compensation and retaliation awards: All other things equal, mem-

24 Some form of compensation also occurred in the US – Copyright, where financial compensation was granted to the EC albeit not on an MFN, but on a bilateral basis (cf. O’CONNOR/DJORDJEVIC 2005). In EC – Bananas, the EU and Ecuador also reached an out-of-court settlement involving unilateral compensation.

25 (ROITINGER 2004, pp. 35) shows that ever since the very beginning of the GATT in 1948 up to the end of 2002, compensation has been offered by the temporarily escaping country only in 16 safeguard cases. Moreover, since 1978, there has not been a single notified compensation offer under XIX.3 GATT. Note that in the WTO-period (1995–2002), there has been an average of 4.9 definitive safeguard measures enacted per year, with a sharp increase in the new millennium.

26 Art. 21.3 DSU. In EC – Hormones, for example, implementation of the panel recommendations was requested 15 months after the adoption of the report. (cf. MAVROIDIS/HOWSE 2003, Vol. 6)

bers in breach of the agreement should be indifferent – at best – over offering to liberalize their import markets. Finally, and closely connected to the previous point, an important reason why the current WTO remedy regime prefers suspension of concessions over compensation, is due to the fact that compensation is negotiated not awarded by a third-party (here: the arbitrator). The negotiation space over tariff compensation bargaining is clearly biased against the complainant. Put differently, the complainant has virtually no bargaining power, since the violating Member's fall-back option concomitantly is its best possible bargaining outcome namely to embrace direct trade damage claims while enjoying the hit-and-run advantage stemming from the RPT premium that Art. 22.3 DSU grants.²⁷

In sum, counter to the oft-cited claim that the prospect of being retaliated against serves as a strong deterrent against breaching a WTO agreement, we conclude the opposite: the prospect of having to endure retaliation neither deters breach,²⁸ nor do Members rush to avoid this situation by offering tariff compensation to the injured country instead. Retaliation is the preferred real-life WTO remedy due to the *de facto* procedural and structural discrimination of the remedy of tariff compensation.

27 This point requires some elaboration: Compensation negotiations happen "in the shadow of retaliation awards" (CHARNOVITZ 2002a, p. 428). This means that the injurer's fallback option of embracing retaliation sets the bargaining space for compensation negotiations. Consequently, the violator will never settle for anything less than its ultimate alternative. The complainant, on the other hand, will naturally only enter into the negotiations if it can barter for anything in excess of the reimbursement of direct trade damages (which it will get awarded through retaliation awards, anyway). But no higher amount than that will be acceptable to the violating party: It rather will let negotiations break down and comfortably contend itself with enduring retaliations amounting to the direct trade damages (if at all). Any proposition offered to the convicted defendant, then, will be so ridiculously much lower than the real expectation damages incurred (which amounts to efficiency losses plus direct trade damage) that the complainant cannot accept if he wants to save face at home. (BOWN 2002, p. 56) notes on this subject: "Working from the perspective that retaliation is used only as a threat and that negotiators use this threat as a 'benchmark' to establish parameters from which to negotiate an efficiency-enhancing, non-retaliatory outcome, the factors that affect the retaliation's impact on this welfare benchmark are critical."

28 In support of our conjecture of weak deterrent effect of retaliation see (MAVROIDIS 2000, pp. 807); BUTLER/HAUSER (2002); (LAWRENCE 2003, chapter 2), or (BOWN 2002, p.56). The critical reader might object to our harsh assessment of the ineffectiveness of tariff retaliation as deterrent. True, the overwhelming number of cases notified to the WTO DSB has been settled between the parties before the dispute reached the panel stage and before the panel reached a ruling (46% and 13%, respectively; cf. REINHARDT/BUSCH (2005) for the period 1995–2002). We offer two responses: First, of 65 adopted panel reports between 1995 and 2002 many did involve 'large country' complainants, where (political or economic) deterrence regularly worked vis-à-vis a smaller convicted violator. Second, early settlement of cases and offers of tariff compensation are the wrong counterfactual to our argument: What counts is the total number of non-compensated breaches of mutual tariff concessions that bring the negotiated tariff equilibrium out of balance cf. (CHARNOVITZ 2002b, p. 411). Alternative opt-out mechanisms, including use of antidumping, countervailing duties, safeguard actions, and non-tariff red-tape measures, are regularly used by policymakers. These policies often do not even get contested in front of the DSB (more on this *infra*).

We end this chapter on note of caution: So far, we have engaged in a direct comparison between the two enforcement reactions to legal breach of a WTO agreement. We have examined the theoretical superiority of tariff compensation over the imposition of retaliatory tariffs from a welfare-economic point of view – and how this actual legal hierarchy gets frustrated *de facto* by the WTO rules and procedures. But that is far from the whole picture. There is a deeper issue here that extends the realm of WTO DSB and its enforcement mechanisms: In times of high domestic economic pressure or extreme political shocks WTO Members have regularly chosen to temporarily escape the contractual obligations they had previously undergone. Thereby they have used the full range of formal and informal escape mechanism that the various WTO agreements offer. We will show that temporarily opting out of the obligations is a rational behavior for self-interested policymakers and that it is equally rational to do so in the least costly way. If we demand that countries compensate the victims of their treaty breach adequately and if we want to revitalize the use of tariff compensation pursuant violations of WTO agreements, we have to take a policymakers' point of view and first understand just what makes the remedy of compensation so unattractive to them, and compared to which alternatives. These are the questions that we aim to tackle in the next chapter.

3 The deeper issue: The political economy of WTO opt-outs

Political-economic considerations help us understand the trade-offs connected with the decision whether to offer tariff compensation to the injured Member government or not.²⁹ We need to take a step back and examine the practical political considerations of Member governments and the incentive space of trade-policymakers. The point of departure for our political-economic analysis of trade remedies is not the examination of the complainant party and its economic ability, or willingness, to retaliate. Instead, the center of attention is the trade-policymaker of the "escaping" party, who is in material breach of the WTO.

²⁹ For an excellent introduction into the political economy of the WTO see SYKES (1991) and SCHWARTZ/SYKES (1996). RODRIK (1995) delivers an overview over the literature of 'endogenous tariff policy', i.e. the political economy of special interest group policies and domestic trade-making.

Our explanation, now, for why “compensation is a rare event”³⁰ (PAUW-ELYN 2000, p. 337) is that policymakers under the current WTO regime have “cheaper”, more convenient opt-out mechanisms to readily choose from. Given the spectrum of possible protectionist means at hand, it can be shown that tendering tariff compensation is a politically expensive, awkward, cumbersome undertaking. Therefore, as things stand today, offering tariff compensation is an irrational act for the self-interested political entrepreneur. The relative “unattractiveness” of tariff compensation is a profound systemic flaw of the system and stands in striking contrast to its normative superiority.

Economic theory of incomplete contracts,³¹ as well as factual evidence of nearly 60 years of GATT- and WTO history tell us that policymakers frequently choose to abrogate multilateral trade concessions in order to offer temporary import relief (viz. protectionism) to certain industries and sectors. Thereby it is irrelevant whether the policy opt-out is being chosen for extraordinary economic emergency reasons or due to domestic political pressure.³² To be sure, the WTO has foreseen contingencies that will permit to Members to temporarily abrogate an Agreement by providing for emergency actions under Arts. XIX (safeguards), XX (general ex-

30 As was mentioned before, tariff compensation by the losing Members is not only part of Art.22 DSU. There are further trade instruments that embrace the notion of compensation – embodied e.g. in Arts. XIX (“emergency action on imports”, also known as safeguards) or XXVIII (tariff renegotiations) of the GATT. Neither of these measures are particularly popular to WTO members, and when enacted, compensation has not always been offered to the injured party (see fn. 25 for details).

31 Economists typically understand the WTO and its Agreements to be ‘incomplete’ contracts. „That is, because of complexities of the relationship among the parties and the difficulties of anticipating all future contingencies, it is impossible to provide expressly for all the ways in which the bargain may require adjustment down the road.” (SYKES 1991, p. 290). Cooperation theory unambiguously asserts that states would not have undergone the significant and far-reaching constraints of the WTO without having had at hand an emergency ‘safety valve’ that allowed them to opt out of an Agreements expeditiously and efficiently (ROSENDORFF/MILNER 2001, p. 832); (ROSENDORFF 2005, p. 394); (ETHIER 2001a, (HAUSER/ROITINGER 2004, p. 653); (LAWRENCE 2003, p. 40). As convincingly argued by ALAN SYKES, economists claim that not only are flexibility tools essential to policymakers, but breaching a contract (while compensating the other party for expectation damages) is efficiency- and thus welfare-enhancing (the so-called “efficient breach hypothesis”; cf. SCHWARTZ/SYKES (2002); (SYKES 1991, p. 281, 2000, p. 352); (DUNOFF/TRACHTMAN 1999, p. 31); ETHIER (2001a, 2002). Thereby, it is of little concern to economists (or, for that matter, to policymakers) that the WTO places compliance with the Agreements as the key objective of the trading system and that not all opt-out mechanisms are in accordance with the official rules cf. (BOWN 2002a, pp. 49). This *Realpolitik* view of the WTO is a point of contention between economics and trade lawyers, who pose compliance with the WTO Agreements as the end-all and be-all of WTO DSB (cf. fn. 8).

32 We want to emphasize that the assessment of how often opt-outs of GATT and WTO Agreements have occurred over the last 60 years is next to impossible to conduct. Obviously it is not the number of notified trade disputes that matters here. Rather, what does constitute the sum of protectionist measures is the unknown number of unchallenged WTO violations, the number of legal opt-outs, and the enormous number of protectionist measures happening in the shadow of legal loopholes (such as antidumping, anti-subsidy, technical barriers to trade or sanitary measures). See also fn. 28.

ceptions) or XXI (security exceptions) of the GATT (and according provisions in the GATS, TRIPs, etc.), as well as the Agreement on Safeguards (SGA) that is linked to Art. XIX GATT. These rules lay out the requirements for a transitional breach of trade law. However, over and above these official opt-out mechanisms, there is a range of informal ones that are apt to operate as *de facto* policy flexibility tools and therewith allow for protectionist policies. These informal opt-outs are:³³ i) the imposition of antidumping actions (AD); ii) countervailing duties (CvD); iii) *violation-cum-retaliation*³⁴; and iv) compensated violation of an Agreement.

Given this broad spectrum of domestic protectionist tools at hand, why do rational policymakers thwart the normative hierarchy that welfare economics would command? Policymakers will typically favor antidumping action over countervailing duty measures over *violation-cum-retaliation* over safeguard action over compensated violation.³⁵ It seems important to notice at this point that we do not assume that Member governments and their policymakers are malicious or devious in the sense that they ignore DSB rulings for the fun of it. Neither do we mean to imply that under no circumstance they would agree to pay compensation. Instead, we merely argue that policymakers will make rational cost-benefit analyses for themselves. Based on these they will decide what is best for them in the immediate, mid-term and long-term future. Loosely speaking, political decision makers will opt for the “cheapest” political solution.

3.1 Antidumping-action: The opt-out mechanism of choice

A rational trade-policymaker (irrespective of the economic size and clout of the country), is constantly under enormous domestic pressure (be it from exporters, import-competing lobbies, importers, or consumers). Most likely this decision maker has to react quickly to an internal political or

33 For detailed information on how those opt-out mechanisms function, what makes them qualify as such, and what the legal enact requirements are, we refer the inclined reader to (ROLLINGER 2004, chapters 2 and 5), for a thorough academic introduction.

34 Under *violation-cum-retaliation* we understand the behavior of uncompensated breach of a WTO Agreement, where a violator deliberately breaches the WTO, loses a litigation, doesn't comply, reaches no bilateral negotiation on compensation, lets pass the reasonable period of time, stays recalcitrant, goes through an arbitration procedure, and awaits the victim party's imposition of tariff retaliation measures.

35 See BOWEN (2002a, 2002b) for the empirics on protectionist opt-outs. The author shows that there is a striking imbalance between little used ‘legal import protection’ under Arts. XIX and XXVIII GATT and briskly enacted ‘illegal activity’ (including AD, CvD, *violation-cum-retaliation*, VERs and other dubious policy measures).

economic shock and feels compelled to afford protection to a domestic industry or sector. Provided the respective country has in place an AD code and the domestic AD investigation authorities manage to construct a legitimate dumping charge,³⁶ initiating AD action against the most competitive foreign exporter(s) for a number of reasons is the policy measure of choice for the self-interested policymaker.

No compensation has to be paid: While domestic import-competing industries will be comfortably behind protectionist walls, AD measures have the unbeatable advantage that no harm is usually inflicted on domestic exporters, since compensation will not have to be offered by the enacting country (cf. e.g. BOWN 2002a, p. 50).

Self-initiation, self-examination, self-execution: Thanks to the extremely strong deferential standard of review mandated by Art. 17.6 of the AD Agreement (ADA), national AD authorities have immense leeway in initiating and investigating dumping allegations – largely unchecked by the WTO or any other multilateral organization.³⁷ Coupled with the myriad of loopholes, ambiguities, and logical inconsistencies of the ADA, the floodgates to unfettered protectionist AD action are wide open (see LINDSEY/IKENSON (2003), who uncover the systemic flaws of the international rules on AD in painful detail).

AD is financially lucrative: “Dumped” imports from specific foreign exporters are burdened with additional, punitive taxes equivalent to the alleged dumping margin. Thus, all countries, economic size notwithstanding, will earn tariff revenues (that can then be redistributed domestically). Large countries can incur significant terms-of-trade gains from raising

36 To be sure, officially AD is strictly to be used against unfair trade practices of foreign exporters. However, AD is a highly fungible tool that is all too easily turned into a protectionist measure. Textual ambiguities and deliberate loopholes in the AD Agreement, coupled with an extremely strong deferential standard, make finding evidence for dumped imports a measure of formality today rather than an obstacle for domestic authorities, e.g. BARFIELD (2004), HUFBAUER/GOODRICH (2003b), LINDSEY (1999), LINDSEY/IKENSON (2003), IKENSON (2001), BOWN (2002a, 2002b).

37 Art. 17.6 ADA reads in pertinent parts: „If the establishment of the facts [of the investigation] was proper and the evaluation was unbiased and objective, even though the panel might have reached a different conclusion, the evaluation shall not be overturned.” Given that the ADA completely lacks i) a clear objective of antidumping; ii) a concrete methodology; and iii) calculation standards for dumping margins, injury and dumping tariffs, on what basis can a panel ever assess whether the domestic valuation was unbiased or objective? Article 17.6 ADA comes very close to a *carte blanche* for domestic AD authorities. The various dispute panels dealing with questionable AD conduct could only punish the most blatant infringements by AD authorities that remained within the panels’ (limited) competence (cf. fn. 59 below).

their tariff barriers (BAGWELL/STAIGER 2002; GROSSMAN/HELPMAN 1995; ETHIER 2001a).

AD action is a targeted measure: AD allegation and determination can be precisely targeted against specific countries, sectors and even firms. Protection does not have to happen in a “shotgun approach” – it can be pinpointed accurately. With this discriminatory measure, foreign outrage over the AD action will potentially be smaller and domestic consumers are harmed less than under any other multilateral policy.

Possibility of VER-type side-agreements: Next, even if the country whose exporting industry is affected by the AD measure is voicing its opposition, the two countries can negotiate (illegal) side-agreements, so-called “price undertakings”. BOWN (2002a, p. 53) suggests that AD action offers a loophole to engaging into managed trade and to revitalizing voluntary export restraint (VER)-like arrangements with powerful exporters (that were banned pursuant the Uruguay Round, since they severely undermine the multilateral spirit of the world trading system).

Uncertainty plays in favor of the initiating country: In case a domestic AD measure gets challenged before the WTO DSB, uncertainty is on the initiator’s side. The AD victim may withdraw its challenge; the litigation might not reach a positive verdict; or the victorious country might be too small to retaliate. In any case, uncertainty fully plays in favor of the initiator.

No economic downside: If push comes to shove, and the enacting country loses the trade dispute over adequacy and legality of its AD actions, and consequently faces retaliation, there is still no immediate economic downside to the matter: First, whereas the relief to importer-competing industries by the AD action is prevailing from the moment the dumping duties are levied, retaliation most likely will be granted prospectively from the moment the arbitral panel reaches its verdict. That way, excessive foot-dragging and procrastination tactics pay well off for the offender. A protectionist measure can be in place for up to four years before a case in front of the WTO is lost – time enough to give the domestic industry a breather. And even after the retaliation awards are spoken, the country can decide to swiftly comply with the panel verdict and withdraw the violating measure of concern – at zero cost to its exporters.³⁸ Second, the

³⁸ A stellar example of successful foot-dragging strategies that ended in a sudden withdrawal of the violating practices were the Bush Administration’s steel safeguards in the early 2000’s. See HUFBAUER/GOODRICH (2003a, 2003b).

country in violation may decide to stay recalcitrant and to keep up the injurious import protection. The maximum compensation the injured party can bargain for,³⁹ or alternatively, the maximum verdict of the WTO arbitrator pursuant Art. 22.6, will be a punishment commensurate to the damage done (in the form of reimbursement of AD-duties collected). This is not more or less than the country would have paid under any other opt-out scheme.⁴⁰

The one thing that might prevent the rational policymaker from initiating AD measures, and indeed the only real disadvantage of this policy instrument is so-called “retaliatory” AD action by the victim Member. And true, retaliatory dumping has proliferated vastly throughout the last decade.⁴¹

3.2 Countervailing duty action: More of the same for protectionist policymakers

A largely identical reasoning to the one brought forth for the trade remedy of antidumping is valid for the policy instrument of countervailing duties (CvD).⁴² Though the two measures differ in prerequisites for enactment, procedures and enforcement consequences, the political-economic reasoning for using these two opt-outs can be applied largely interchangeably.⁴³ Therefore we shall refrain from giving a full-blown analysis of the political merits of CvD action to the policymaker.

3.3 Violation-cum-retaliation: A fairly “cheap” policy option

The next-best option after the two contingent protection mechanisms AD and CvD for the self-interested policymaker clearly is to opt for *violation-*

39 Remember that compensation negotiations between injurer and complainant occur in ‘the shadow of retaliation awards’ (cf. *supra* fn. 27).

40 BOWN (2002a) remarks on compensated opt-out measures: „[The] imposition of even a (statutorily) dubious AD measure that is certain to result in a formal trade dispute [is] preferable to utilization of the safeguards provisions” and “If authorizable retaliation-as-compensation is *identical* under both the DSU and the [Agreement of Safeguards], what economic incentive would a country ever have to use the safeguard provisions? [...] In the worst-case scenario the protection-affording country lost the dispute, it would only have to yield the same compensation as it would have faced under the safeguards provisions.” (pp. 49, 56)

41 For empirics on retaliatory AD, cf. PRUSA/SKEATH (2002), and FEINBERG/OLSEN (2004).

42 CvD actions are regulated by the Agreement on Subsidies and Countervailing Measures (SCM).

43 See (ROTTINGER 2004, chapter 5.3). One of the few constraints for policymakers (and their authorities) is to prove the incidence of (prohibited) production- or export subsidies – not the most difficult task given the little restrictions the SCM Agreements puts on enacting countries.

cum-retaliation, which means to breach a respective WTO Agreement, to stay recalcitrant and to then accept tariff retaliation enacted by the victim Member.

Retaliation is uncertain to occur and potentially harmless: Retaliatory suspension of concession requires the affected Member to have the capacity to retaliate. After all, the victimized country might decide not to do so. And even if a small country retaliated by raising tariffs, it is very unlikely that it would possess the capacity to assemble the amount of retaliation force that would be needed to cause noticeable pain to the large perpetrating country – at least not without shutting down most of its own economy. Therefore, rather than to “shoot themselves in their foot”, small countries may end up not retaliating, which, of course, is good news for the violator.

Procrastination always pays off: As noted before, retaliation awards are considered the *ultima ratio* of the system and are only awarded if all alternatives are fully exploited and have proved futile. Thus foot-dragging tactics that exploit this time advantage to the maximum unambiguously pay off. They can buy the protected industries valuable time at no economic cost (a “hit-and-run” advantage), since remedies are usually effective prospectively.⁴⁴

Retaliation is an indirect policy measure: As ETHIER (2001a, 2001b) points out, domestic political support is regularly more sensitive to direct government action than to indirect consequences thereof. In the realm of trade policy, protection of a certain sector has a certain direct effect: Import competing industries know exactly thanks to whom they enjoy the protectionist proceeds. If the protection measure is contested at the WTO, policymakers show that they “fight like lions” for their import competing constituents and get full credit (in form of, say, campaign contributions) for standing their ground firmly. Yet, policymakers will only get partial blame for the indirect consequences of the contested protectionist measure. Domestic exporters and consumers will not fully make the link

44 Note that the DSB process is fraught with opportunities to game the system and to slow down the speed of litigation. The most powerful procrastination strategy is to swap one non-compliant measure with another one. The new measure will then have to be disputed over in a new panel case (as happened in the EC-Bananas cases or when the USA replaced their tax refund system for Foreign Sales Corporations with the ‘Extraterritorial Income Exclusion Act’). The US – FSC/ETI case took 7 years to get resolved from its initiation to the retaliation authorization by the WTO (LAWRENCE 2003, p. 74). Clearly, this time lapse tends to play in the defendant’s favor.

between the breach of the contract on the one hand and the WTO-sanctioned international repercussions it provoked.⁴⁵ In the face of defeat in front of the DSB, protectionist policymakers will engage into excessive blame-shifting: Naturally, it will be the “faceless bureaucrats of the WTO” and the utterly unfair trade practices of the exporting member (engaging in labor- and environmental standard violations, exports subsidies, dumping, etc.) that “provoked” the domestic protectionist reaction.

All these advantages of *violation-cum-retaliation*, to our mind, outweigh the concerns that policymakers will have about enacting this protectionist strategy, namely (i) the loss of domestic political support from consumers and downstream industries, (ii) the reputational damage suffered internationally, and (iii) cross-retaliation schemes.

The first concern is minor to the self-interested policymaker: As we noted *supra*, retaliation bears indirect consequences that are rarely ascribed to the original act (i.e. the protectionist measure) by negatively affected parties. In addition, it is a well-known and well-documented fact that consumers and using industries do not have the same political clout with domestic decision-makers as do import-competing industries.⁴⁶ As for the second concern, the reputation loss with international peers, we contend that policymakers do understand the constraints foreign policymakers are faced with – and can be expected to be sympathetic to them. If *violation-cum-retaliation* is indeed a focal strategy for the representative self-interested policymaker (given the necessary political and economic power of the country s/he is representing), every decision maker is prone to act the

45 Technically, exporters and consumers harmed by retaliation resulting from the protectionist measure are conjectured to be partially ignorant about Lerner's Symmetry. (ETHIER 2001, p. 212) explains the different perception of direct and indirect trade consequences very aptly like this: „Suppose, for example, the US reduces sugar barriers and that sugar imports rise. Those in the sugar industry know that the former is responsible for the latter. Suppose the foreign sugar exporters spend their increased proceeds on US wheat and computers, restoring trade balance. Some in the latter industries may credit at least some of their good fortune to the reduction in sugar barriers, but others will credit their own business acumen, general economic conditions, etc. Even if an individual exporter of computers or wheat does realize that an increase in sugar imports must generate an equal-valued increase in exports of something he/she will be unlikely to credit that for the additional sales of his/her product. If, on the other hand, part of the rise in exports of wheat and computers is due to reductions in foreign trade barriers negotiated by the US government, the latter will surely get credit for that.”

46 Sad but true: “elected officials will concern themselves far more with the impact of trade policy on producer interests than on consumer interests” (SYKES 1991, p. 275). We refrain from citing the extensive literature on collective action and special interest group politics to explain why consumer-, exporter-, and using industry interests are chronically less influential in trade policy-making (‘OLSEN's Asymmetry’). Instead, we invite the reader to reflect on the striking clout that the U.S. sugar sector or EU textile manufacturers enjoy with their national trade policymakers and on the enormous perks they managed to carve out for themselves against import-competing market forces ...

same way when encountering a similar domestic situation. Policymakers will demonstrate understanding for their counterparts' immediate constraints. So, the loss of reputation might turn out to be less of a problem than game theorists will make us believe.

Finally, the third – and probably the largest – concern to a recalcitrant violator is the threat posed by so-called “cross-retaliation” actions by the injured Member(s).⁴⁷ The infamous EC – Bananas case co-initiated by Ecuador showed that even economic heavyweights such as the EU are indeed fearful of the possibility of cross-retaliation (especially under TRIPs). In fact, once Ecuador got awarded rights to retaliate in the area of TRIPs, the EU hastened to settle the dispute with the developing country, only in order to avoid a precedent that potentially could open a Pandora's Box and give rise to a recurring series of disputes dealing with essentially the same, dangerous issue. It is beyond the scope of this paper to discuss legality, possibilities, significance and efficiency of cross-retaliation for developing countries extensively. Suffice to say that the issue is an exiting field of research, since for the first time it could truly provide developing countries with an effective legal remedy.⁴⁸ To countervail premature enthusiasm about cross-retaliation, however, a closer reading of the EC – Bananas case shows that its jurisdiction does not turn the instrument into a panacea for developing countries: The dispute panel in Bananas has been extremely coy and careful in its language so as not to open the floodgates too far. It seems that the panel applied a rather unconventional⁴⁹ legal test of Art. 23.3(c) DSU. Especially the panel's interpretation of the pertinent clauses “practicable” and “effective” (see footnote 47) is highly restrictive making the decision “less illuminating than it might have been” (HUDEC 2002, p. 89).⁵⁰ The panelists were apparently

47 Art. 22.7 DSU authorizes the arbitrator to exercise judicial review over the *area* of the imposed retaliatory suspension of concessions. The arbitral panel may allow retaliation to occur under another Agreement if it considers: „That it is not *practicable* or *effective* to suspend concessions [...] with respect to other sectors under the same agreement, and that the circumstances are serious enough” (Art. 22.3(c) DSU; emphasis added).

48 Ironically, cross-retaliation was originally drafted by representatives of the developed world (against the vehement objections of developing countries) as an instrument to enforce the TRIPs agreement against intellectual property infringements. According to HUDEC (2002, p. 89) the Uruguay negotiators never fathomed that the instrument could be used as a vehicle for developing country retaliation in GATT/GATS disputes. The Bananas case, however, turned the tables and transformed cross-retaliation (in form of suspension of certain obligations under TRIPs) into a potentially powerful deterrent tool.

49 The late ROBERT HUDEC called the panel's test “superficial and inconsistent” (HUDEC 2002, p. 90).

50 Given that the EC's violation was in goods, the arbitrators did not fully support Ecuador's request to take retaliatory measures under TRIPs only, but instead demanded the country to exhaust the possibilities for retaliating against imports of EC consumer goods first, before being allowed to retaliate under other sectors and finally under TRIPs.

not thrilled by the legal and political implications a proliferation of cross-retaliation would entail and feared “ripple effects”.⁵¹ Ecuador’s retaliation request in the Bananas case, therefore, can only be seen as a very tentative first step in a much longer journey.

To sum up: Non-compensated persistent injury of a WTO Agreement, followed by the acceptance of tariff retaliation against one’s exports is a very attractive policy option for governments – despite the concerns about domestic opposition, reputation abroad, and possible cross-retaliation.

3.4 Compensated opt-outs: The short end of the policy stick

There are two temporary opt-out mechanisms in GATT that embrace the concept of tariff compensation in order to re-establish the bilateral or multilateral balance of tariff concessions. One is the (legal) safeguard action, the second is the (illegal) compensated treaty violation. In the previous chapter we noted that, compared to the remedy of *violation-cum-retaliation*, tariff compensation is strictly welfare-enhancing. Also, compensating trade partners for the damage inflicted upon them can be considered as a fair measure. However, we cannot expect fairness, spirit of liberalization, or the well-being of foreign exporters to feature very prominently in self-interested policymakers’ own utility functions. Offering compensation to trade partners comes at too high a price for them. A closer look at the political downside of using compensation-based policy opt-outs bears interesting aspects.⁵²

Offering tariff compensation is an official admission of guilt and incompetence: Offering the violated Member tariff compensation commensurate to damages incurred (as DSU Art. 22, and Arts. XIX and XXVIII GATT posit), is nothing short of a political admission of guilt. With openly granting compensation a policymaker not only officially concedes that s/he has offered blatant protectionism to a specific sector (probably for

51 “As the arbitration panel itself made clear, however, [cross-retaliation under TRIPs] will involve a number of distinctive legal, practical, and economic problems for the retaliating state. The panel delivered a lengthy lecture on the prospective perils of such retaliation.” (HUDEC 2002, p. 90). For critical remarks on cross-retaliation along these lines, see CHARNOVITZ 2002a, p. 421.

52 Note that all the advantages of the other, non-cooperative, policy tools mentioned above were measured against the yardstick of tariff compensation, so what is mentioned as an upside factor *infra* at the same time is to be understood as a disadvantage of tariff compensation.

selfish reasons – or, may we dare say: corruption?). Also, s/he will then go on and liberalize (read: “punish”) other sectors that have nothing to do with the policymaker’s “dirty protectionist business”. This is a recipe for provoking domestic stirrup. Had the policymaker instead carried on with a long-winded WTO litigation, fought like a lion against the unrighteousness of being suspected of protectionism, lost in honor, stayed recalcitrant (“we will not be bullied by the WTO!”), and accepted the retaliation under vehement objection, voters and exporters either would have forgotten about the issue, or would perceive the policymaker a fighter and not a loser.

Compensation is a direct measure: Offering tariff compensation comes across as an admission of guilt to stakeholders, since it is so utterly transparent: It is a direct measure whereby the connection between cause and effect is a straight forward case to anybody. Collective action dynamics will probably bring out the violent opposition of the (concentrated and well-organized) losing industries. These lobbies of the liberalized import-competing sectors will be quick to point to huge job losses and dumped imports of inferior quality that are now swamping the domestic market – due to the compensatory measure. On the other side, the mass of consumers who will gain in real terms from the measure is too fragmented and too large to feel the impact of liberalization – and hence will care too little about it to counterbalance the losing industries’ opposition.

Compensation has to be offered on an MFN basis:⁵³ It is not old-fashioned mercantilism that makes policymakers believe that offering “MFNed” liberalizations is bad, but rather enlightened self-interest. Paying off an injured country for trade damages done to it is one thing. A unilateral liberalization on an MFN basis to every country is another issue and will cause major repercussion from affected domestic parties. Also, the compensation bears the potential to upset the (carefully carved) multilateral balance of concessions in a way not hitherto planned by trade policymakers.

Compensation is costly – terms of trade and time gains are foregone: If the enacting party is a “large” country, tariff compensation internalizes the terms-of-trade externalities incurred on the trading partner(s) through

53 Art. 22.1 DSU makes clear: „Compensation is voluntary, and, if granted, *shall be consistent with the covered agreements*” (emphasis added). No doubt that this includes the fundamental principle of MFN.

the initial protectionist policy.⁵⁴ By offering tariff liberalization in some other industry than the one protected by the non-compliant measure, the injuring party re-establishes the initial terms-of-trade balance. It therefore fully pays the bill for its own actions. This is fair, but inconvenient to the policymaker.

In addition compensation is likely to be costly to any small or large protectionist country due to the foregone foot-dragging gains of the kind explained above: Compensation negotiations can take place throughout the dispute process, that is, mutual settlement is possible all the time. However, compensation will always be offered by the breaching Member prior to its embracing retaliation. If compensation is offered under the safeguards regime, the lost time advantage is likely to be even greater: Compensation offers by the violating party under XIX.2 GATT are due instantaneously, i.e. at the time of the enactment of the safeguard measures, whereas a three-year grace period against retaliatory suspension of concessions is granted under Art. 8.3 SGA. In both cases, the strategy of waiting and being retaliated against (which may or may not happen) – and meanwhile continuing with the injuring original measure – is superior to negotiating trade liberalization commitments with the injured country early on in the process.

Compensation is negotiated and not self-executing: As we pointed out before, tariff compensation under Art. 22.2 DSU is happening in an unstructured, unmediated negotiation process, in which the offender has no incentive whatsoever to settle for anything more than his reservation utility, which is what it would face with retaliation (calculated as trade damage awards plus reputation costs minus foot-dragging advantages). This renders chances for a negotiated settlement more than dim. In addition, compensation is not self-executing, since it has to be offered voluntarily by the violating Member. But coming forth and offering liberalization (and thereby enacting administrative costs) is politically much trickier than to “sit it out”, to wait and see how the injured party is going to react.

It is a matter of taste of policymakers, now, whether they perceive safeguard actions under Art. XIX GATT or compensated breach of the WTO

54 BOWN (2002a) remarks in the context of safeguards: “If the safeguards provisions include a *compensation* requirement, then a protection affording country that resorts to the escape clause over AD measures is stating in effect that it is willing to internalize more of the economic costs of the protection.” (p. 51).

under DSU Art. 22 to be less attractive: Safeguard actions have a high threshold of application for the enacting country,⁵⁵ but then the SGA (Art. 8.3) grants the three-year grace period before the enacting country has to offer compensation. Compensated violation under Art. 22 DSU, on the other hand, does not come with procedural conditionality attached, but inflicts onto policymakers reputation damages of a lost litigation, as well as the cost of going to court. However, the violating country still has chances of actually winning the case, at least partially. Note that we can expect the amount of compensation to be lower under the DSU-regime, since the time of reference is different under the two mechanisms. The time lapsed due to the lengthy trade litigation under the DSU procedures is probably not going to be considered in the injurer's compensation offers.

To sum up: If there exists a normative presumption that compensation shall obtain a prominent and in fact primary role in WTO dispute settlement according to its welfare-economic superiority (as we hope to have made the case in the previous chapter 2), we have to encourage the use of tariff compensation. Proposing simple reforms to do so by making compensation more attractive, however, won't suffice. In order to get the whole picture, we took account of real-life constraints and submitted why compensation currently is deemed such an unattractive option by policymakers. We examined what features, on the other hand, make policy flexibility tools like antidumping or *violation-cum-retaliation* preferred policies. We are now ready to suggest effective reforms that make compensation more attractive to use and that, at the same time, make other inefficient and legally questionable instruments less convenient to utilize, while leaving open the opportunity for much-needed opt-outs to policymakers.

4 How to make compensation more attractive: Agenda for reform

In this chapter we synthesize our findings from the earlier sections and suggest our agenda for reform. Normative by its very nature, this agenda is not a small one and borne by politico-economic thinking rather than strict legal principles. As has become clear from the previous chapters, the

55 According to MAVROIDIS/HOWSE (2003), for a safeguard measure to be imposed, a country must show that "i) as a result of unforeseen development; ii) imports in increased quantities; iii) have caused or threatened to cause: serious injury to the domestic industry producing the like product." (p. 686, Vol. 6). As SYKES (1991) contends, these requirements undercut the political utility of the escape clause. See also (ROTTINGER 2004, p. 102).

provision of tariff compensation – while being economically vastly superior – is underused, mainly because i) it is not supported by any official procedure or mechanism within the DSB, and ii) has much less political appeal for the self-interested policy-maker than other palpable opt-out mechanisms. It was mentioned *supra* that there is a presumption in WTO jurisdiction that the remedy of compensation is quantitatively equivalent to the one of retaliation, and that both can be used interchangeably at the same cost to the violator: WTO Members appear to have the choice of whether to propose a liberalization package worth X US\$ in compensation (by lowering tariff in specific markets), or to endure a “punishment” of tariff retaliation against domestic exports worth the same amount. In chapter 2 we argued that this is wrong from a normative standpoint. Chapter 3 demonstrated why – given this alleged equivalence and the possibility of choice – policymakers regularly decide against compensation and in favor of other opt-out mechanisms.

Obviously, there is a clear gap between what is and what should be in the WTO enforcement system. Our reform agenda comprises of three broad avenues of reforms, namely a substantive reform, a procedural reform, and a profound re-interpretation of WTO enforcement. In the following, we propose to first remodel substantially the present AD and CvD codes and to strengthen the policy tool of compensatory safeguards. Second, we strive for giving compensation an equal procedural footing in the official arbitration process of Art. 22 DSU. Third, we suggest a re-interpretation – and thus re-evaluation of the presumed calculative equivalence of tariff compensation and retaliation. In particular, we suggest introducing a quantitative wedge between compensation and retaliation awards. There-with, a deliberate bias by DSB arbitral panels in favor of compensation awards is achieved, which may lead the rational policymaker to rethink his preference for embracing retaliatory tariff hikes.

4.1 Substantive reform

We contend, as have various pundits, that the WTO system has to be modified in a way so as to make safeguard provisions relatively more attractive, since they provide for a proper compensation of the injured party or parties – without having to lead a tedious and lengthy litigation over its amount. Thereby we concur with BOWN (2002), who suggests that:

“Changes designed to affect [the more frequent use of the safeguards regime] must be coordinated with reforms to the WTO’s rules on antidumping, dispute settlement and retaliation and compensation.” (p. 50)

This is exactly the plan of our reform agenda. As a first step we contend that the AD and CvD codes of the WTO have to be fundamentally reformed.⁵⁶ It seems absolutely clear that AD and CvD actions today are predominantly used as opt-out tools for protectionist reasons and that the recourse to them as “unfair trade remedies” is a barely veiling fig leaf.⁵⁷ It is time to reform the two codes in a manner that fits their mandate and their original intent. A fundamental overhaul of AD and CvD regimes would consist of an agreed-upon set of core definitions and principles (giving answers to trivial questions like: “What is dumping and why is it harmful?”, “What are fundamental objectives and justifications for AD- and CvD action?”, or “What exactly constitutes remediable ‘unfair trade’?” etc.⁵⁸), a myriad of technical reforms,⁵⁹ a serious reduction of national discretion and standard of deference, and a consideration of basic economic reasoning. Since both trade remedies have hardly any economic basis

56 We are definitely not the first ones to demand a radical reform of the WTO trade remedy codes and refer the interested reader to the work of others who have made this point more aptly than we can develop here. Profound reform proposals of WTO trade remedy laws have been made by LINDSEY/IKENSON (2003); HAUSER/ROITINGER (2005); HOEKMAN/MAVROIDIS (1996) or BOWN (2002a). Most of these authors discuss the substitution of AD by antitrust regulation. HORLICK/PALMER (2002) focus on the relationship between CvD and antitrust. (ROITINGER 2004, p. 193) provides for a good literature review.

57 According to MESSERLIN (2000), less than 10 percent of all antidumping cases have even a slightest chance of being considered as ‘predatory-’ or ‘strategic dumping’, the two only economically noxious categories. cf. WILLIG (1998). The vast majority of AD measures is driven by protectionist motivations and thus de facto constitutes safeguard actions.

58 It is striking that nowhere in the ADA or elsewhere in the GATT can we find an attempt to define the basic economic and social precepts, principles and objectives that would justify AD action. The only thing we can find is how “dumping” is determined, but not what exactly makes it pernicious. The negotiators simply seem to have assumed that every country will enact its proper AD rules and regulations on similar standards. This assumption, however, proved futile and we witness a severe regulatory and methodological heterogeneity in AD codes today. Given the very strong deferential standard of review of Art. 17.6 ADA, disagreement is predetermined.

59 At the very least, a reformed AD code should integrate the technical recommendations articulated by previous AD litigation panels. As we stated before, the panels’ competence of countering protectionist AD measures is very weak. Nevertheless, dispute panels and AB in the past have brought forth recommendations on the practices of ‘averaging’ (Korean Steel case); ‘zeroing’ (EC – Bed Linen); constructed values; cumulative assessment of injury; the *de minimis* rule (Japanese Hot-Rolled Steel); sunset reviews (Korean DRAMS); the causal relationship between dumping and injury (Thailand – Steel and Guatemala – Cement); or the use of ‘facts available’. As said, these are all highly technical, but vastly important issues to reform. The interested reader is referred to BARFIELD (2004) and HUFBAUER/GOODRICH (2003a).

anyway,⁶⁰ it would be best to eventually do away with the two codes completely and integrate AD and CvD into domestic competition law. Antitrust agencies have effectively dealt with anticompetitive and monopolistic tendencies and have a long track-record of applying sound and coherent systems of economic reasoning when assessing the real economic impact of domestic dumping practices (BARFIELD 2004 and MES-SERLIN 2000).⁶¹

Only a reform of AD and CvD codes prepare a fertile ground for a successful revision of the safeguard regime under Art. XIX GATT and the SGA. In fact, a substitution of protectionist trade remedy measures for safeguards would be the second best solution (second only to full compliance of the violator and subsequent withdrawal of the contested measure). Safeguards are the central legal opt-out mechanism that the WTO provided for in order to provide temporary escape to policymakers in domestic distress. And this is so for one reason: Safeguards incorporate the idea of compensating trade partners for the harm done to them.

Applying safeguards, however, has to be made easier and more convenient. Prerequisites and threshold levels of application have to be lowered to make way for unimpeded use of the opt-out mechanism if the domestic situation calls for it.⁶² SYKES (1991) contends that high requirements undercut the political utility of the escape clause. ROITINGER (2004); HAUSER/ROITINGER (2005) and others have brought forth reform proposals that confine the policymaker's opt-out menu to efficient and compensated breach under the safeguard regime while discouraging inefficient and discretionary revocations of concessions.

These two substantial reform measures, a radical change in the AD, CvD and safeguards regimes, are well-documented proposals of paramount saliency. It is the next two steps in our reform proposal where we would like to add new spice to the DSB reform debate. In the following two

60 „Although economic theory identifies a few plausible scenarios in which antidumping measures might enhance economic efficiency, the law remains altogether untailored to identifying them or limiting the use of antidumping measures to plausible cases of efficiency gain” (ALAN SYKES; in BARFIELD 2004, p. 15).

61 Further Authors in Footnote 56.

62 Lowering the thresholds of application involves cutting on evidence requirements (such as ‘material’ instead of ‘serious’ injury, or doing away with the requirements of having to prove ‘unforeseen developments’ that the Argentina – Footwear ruling established), as well as the introduction of a sunset clause (periodic review). For further concrete reform proposals, cf. (ROITINGER 2004, chapter 6). For dissenting opinions in favor of higher thresholds and higher prerequisites, cf. (BOWN 2002a, p. 58) and (SYKES 1991, p. 291).

sections we will argue that it is time to rethink and re-evaluate the way tariff compensation and tariff retaliation are treated in the WTO. We first recommend placing both WTO remedies on an equal procedural footing, and we next suggest removing the perceived equivalence between them, while refraining from making compensation mandatory.

4.2 Procedural reform: Placing compensation and retaliation on an equal footing

The second step of our reform agenda concerns chronology and procedures of enforcement mechanisms in the DSU. Determination of tariff compensation has to be given the same institutional weight as arbitration over retaliation awards. Orderly arbitration procedures under Art. 22.6 and 22.7 DSU occur only after unstructured and unmediated compensation negotiations of 20 days after the RPT break down (Art. 22.2 DSU). Arbitration panels are limited to calculating the “right” amount of retaliation awards. Negotiations over compensation offers, on the other hand, occur in an unstructured way prior to the arbitration panel. As we argued before, this puts the remedy of compensation at a significant procedural disadvantage vis-à-vis retaliatory suspension of concessions and therewith exactly counteracts the normative significance that tariff compensation offers bear.

In order to put compensation negotiations on an equal procedural footing we contend that the chronology of enforcement must be overhauled and that determination of tariff compensation awards needs to be incorporated in the official arbitration panel of Art. 22.6 and 22.7 DSU. This way we would explicitly staff the arbitrator with the opportunity to calculate compensation awards and to present the losing party with the choice of whether to offer compensation or to embrace retaliation.

Concretely, this requires three distinct procedural reform steps. First, the wording of Art. 22.2 DSU has to be stripped of its insensible and counter-productive chronology that disadvantages the remedy of compensation. Instead of determining a sequence of first conducting voluntary compensation negotiations and then establishing retaliation awards we propose

to institute concomitance: Au lieu the original wording⁶³, sentence 2 or Art 22.2 should read (proposed revision underlined):

“If no satisfactory compensation has been agreed within 20 days after the date of expiry of the reasonable period of time, any party having invoked the dispute settlement procedures shall refer the matter of compensation to arbitration. Such arbitration shall be carried out as determined in paragraphs 6 and 7 of this Article. In addition, any party having invoked the dispute settlement procedures may request authorization from the DSB to suspend [...] concessions or other obligations under the covered agreements.”

Next, Arts. 22.3, 22.6 and 22.7 of the DSU have to be amended so as to integrate arbitration over nature and amount of compensation awards into the official procedure.⁶⁴ Art. 22.7 should now be reading:

“The arbitrator acting pursuant to paragraph 6 shall present to the Member concerned a compensation package taking into consideration compensation concessions granted under paragraph 3(h). Concomitantly, the arbitrator determines the level of suspensions of concessions or other obligations. The arbitration shall not examine the nature of the concessions or other obligations to be suspended but shall determine whether the level of such suspension is equivalent to the level of nullification or impairment. The arbitrator may also determine if the proposed suspension of concessions or other obligations is allowed under the covered agreement. [...] The parties shall accept the arbitrator’s decision as final and the parties concerned shall not seek a second arbitration.”

63 The original Art. 22.2 DSU reads in pertinent parts (emphases added): „[1] If the Member concerned fails to bring the measure found to be inconsistent with a covered agreement into compliance therewith or otherwise comply with the recommendations and rulings within the reasonable period of time [...], such Member shall, if so requested [...], enter into negotiations with any party having invoked the dispute settlement procedures, with a view to *developing mutually acceptable compensation*. [2] If *no satisfactory compensation* has been agreed *within 20 days* after the date of expiry of the reasonable period of time, any party having invoked the dispute settlement procedures *may request authorization* from the DSB to *suspend* [...] *concessions* or other obligations under the covered agreements.”

64 Sentence 2 of Art. 22.6 DSU only needs a slight amending touch referring back to the failed compensation negotiations under paragraph 3 of the same article (new passages in *italics*): “ [2] However, if the Member concerned objects to the level of suspension proposed, or claims that the principles and procedures set forth in paragraph 3 have not been followed where a complaining party has requested authorization to suspend concessions or other obligations pursuant to paragraph 3(b) or (c), *or if any party having invoked the dispute settlement procedures declares its intension to do so pursuant to paragraph 2*, the matter shall be referred to arbitration [...].” On the purpose of the insertion of a (so far inexistent) Art. 22.3(h), see *infra*.

This extension of Art. 22 DSU would give tariff compensation an equal procedural footing, a distinct quantification, and the same timing as provided for the remedy of retaliation. Moreover, it could present the arbitrator with the possibility to give the losing party the choice of whether to concede to liberalizing compensation offers or whether to accept retaliatory suspension of concessions by the aggrieved party.⁶⁵ Note well that the above-mentioned paragraph 3(h) of Art. 22 DSU so far is inexistent and needs to be incorporated accordingly.⁶⁶ A new sentence (h) could read like this:

“In considering compensation, the Member concerned may provide the DSB and the arbitrator with a compensation package equivalent to the level of the nullification or impairment that is in accordance with the rules and regulations of the covered Agreements.”

This inserted article could now give the defendant the opportunity to submit a pre-selected list of compensation commitments.⁶⁷ When calculating the compensation awards it would be up to the arbitrators to decide whether the compensation offered in those respective industries could suit to the complainant’s rebalancing needs.

4.3 Re-evaluation of legal interpretation: Removing equivalence of tariff compensation and retaliation

As we saw in chapter 2 there is a wide gap between what trade remedies ought to achieve, (viz. the re-establishment of the *status quo ante* the breach by mandating expectation damages from the violating party), and the size of trade remedy awards that have been effectively assigned, which almost always amounted to awards of prospective direct lost trade damages. Apparently, WTO arbitrators have certain latitude over the size

65 In order to avoid strategic gamesmanship on part of the complainant, the choice of remedy is to solely rest with the violator: the complaining party would have to accept the verdict of the arbitrator and the decision of the injuring Member.

66 Art. 22.3 DSU generally deals with the submission of the plaintiff’s retaliation schedule.

67 The reader might be reminded of ROBERT LAWRENCE’s suggestion of “contingent liberalization commitments” (2003, chapter 5). Note that our proposal is different: We don’t suggest that Members *negotiate* their pre-committed sectors *upfront* in a *multilateral* setting. Rather, a losing defendant can *unilaterally* submit an *ad hoc* list of “liberalizable” sectors to a special complainant in the dispute at hand. Strategic and political deliberations on the part of the defendant under Lawrence’s and our proposal will be vastly different (not to speak of practical and organizational considerations incriminated on the entire system by LAWRENCE’s proposal).

and the calculative base of the enforcement awards they grant. We propose to use this legal “wobble room”, or leeway, that arbitrators possess (and that resides within their competence by virtue of Art. 22.4 DSU) in order to do away with the perceived equivalence between compensation and retaliation.

Once the minor procedural change in DSU’s Art. 22 of the kind suggested in the previous subchapter has occurred, the major task at hand is to bring about a perceptive change in the current interpretation of tariff compensation by the WTO Members and DSB jurisdiction. This is largely a shift in perspective and mindset and should come with little legal strings attached. However, in order to manifest this shift in legal interpretation, it will be of vital importance to secure the backing by the body of member states – potentially the largest political challenge ahead.

To be precise: Our proposal envisions the arbitrator to confront the losing party with the option whether it wants to offer less in tariff compensation, or to pay more when accepting retaliation. The DSB has proven that there is ample leeway in two crucial dimensions when determining damage awards: Financially, the maneuvering space spans everything between direct trade damages as a lower bound and reimbursement for expectation damages (direct trade damages plus efficiency losses) as an upper bound. Punitive damages, however, are strictly excluded from WTO enforcement and constitute the enforcement frontier that can’t be crossed.⁶⁸ The relevant time frame of WTO enforcement determinations is spanned between the time the illegal act was committed initially (retrospective application) and the moment the arbitration report is adopted (prospective application). This constitutes the maneuvering space arbitrators have at their command, and this allows for differentiation in treatment between compensation and retaliation. We can see this deliberate discrimination coming in two flavors.

Option 1: The trade-off between direct and indirect trade damages. We see the possibility to let the calculative base of tariff compensation awards be equivalent to direct trade damages (the very calculation that has been prevalent in the DSB so far). More precisely, the arbitrator (who, note, pursuant our proposed reform of Art. 22 DSU has the authority

68 Naturally, the arbitrator cannot and should not propose punitive damages. Punitive damages are clearly out of the logical realm of WTO DSB and hence constitute the upper bound for WTO remedies (see fn. 10 *supra* for references). For an alternative view accepting punitive damages under WTO law, cf. (PAUWELYN 2000, p. 344); (CHARNOVITZ 2001, p. 824; GRANÉ 2001, p.763).

to establish both compensation and retaliation awards) shall set the monetized amount of liberalization and the mix of industries that a non-compliant injurer has to offer to the amount of direct trade lost due to the illegal measure in question.⁶⁹ The novelty, now, is to aggravate the retaliation awards by charging the convicted defendant country to bear the full scope of expectation damages.⁷⁰ The latter amount would be substantially higher than what compensation would comprise of.⁷¹

Option 2: The time factor. Another way of differential treatment between remedies could be to base the calculation of compensation on prospective trade damages, while letting retaliation be based on retrospective trade damages. Although the prospective element of damages in the WTO has been prevalent so far, we fail to see an explicit prohibition of retrospective damages. Also, as noted in footnote 13 *supra* there have been instances of retrospective damages – even under the authority of the DSU, so it is fair to say that the concept per se is not alien to the WTO. HUDEC (2002) notes that developing countries ever since 1965 have tried to lobby for retroactivity,⁷² but it wasn't until a panel in 2000 (Australia – Automotive Leather) concluded:

“[...] we do not believe that Article 19(1) of the DSU [on ‘panel recommendations’], even in conjunction with Article 3(7) of the DSU [on authorization of enforcement measures], requires the limitation of the specific remedy [...] to purely prospective action.”

Hence there seems to be ample room for retrospective determination of damages. The discrimination in trade remedies by any of these two options for the first time establishes a real trade-off for policymakers in the “escaping” country. Facing a hefty retaliation could represent a real deterrent in light of a relatively much more advantageous tariff compensation.

69 As we mentioned before in fn. 10, direct trade damages suffered by the victim are calculated by simply taking export losses times world price decrease times export substitution elasticity.

70 The Sutherland Report (at §243) noted: “Valuation [i.e. the monetized calculative basis for trade damages] would have to consider not only effective losses, but also potential gains that are nullified and impaired.”

71 As we have pointed out before, direct trade damages are a strict subset of expectation damages. The latter are increased by the amount of efficiency losses (the indirect trade damages) incurred by the complainant on account of the original protectionist measure. Only full expectation damages place the defendant in as good a position as it would have been had the injuring country performed. Efficiency losses are equivalent to opportunity losses (LAWRENCE 2003, p. 36) and include various costs like (the net present values of) profits foregone, lost economies of scale and scope, market-searching costs, production-switching costs, production downsizing costs (cf. fn. 10).

72 Recent developing countries proposals towards retroactivity include Mexico and India's submissions to the WTO, cf. DIEGO-FERNANDEZ (2004) and WTO Doc. WT/DS/W/23 and WT/DS/W/40.

Liberalizing trade, instead of recalcitrance, could be a worthwhile option to protectionist governments.⁷³ Note that we are not proposing any compulsory element here that mandates Members to pay tariff compensation (as do other “compensationist” proponents, cf. fn. 5 for references).

Apart from a minor procedural reformulation of Article 22 DSU (which saves WTO Members excessive re-drafting of DSU language), our reform proposition asks for one more or less radical change: that in legal interpretation and therefore in perception. Arbitrators (usually panelists and AB judges), but also the representatives of the WTO Members have too rarely questioned the rebalancing paradigm (which doesn’t really rebalance, as we argued in chapter 2) and the *raison d’être* of alleged equivalence of the two enforcement mechanisms of tariff compensation and retaliatory suspension of concessions. Mind, this equivalence is not written down anywhere in the WTO. Never has a panel had to pit tariff compensation under Art. 22.2 DSU against the remedy of retaliation under Art. 22.6 DSU. These two remedies “never crossed paths”, so to say, and hence nobody has ever written about their direct relationship, let alone decreed their equivalence. Furthermore, an explicit prohibition of retaliation awards *in extenso* of direct trade damages exists nowhere in the WTO. It merely exists in the interpretation history of the DSB. This interpretation potentially could be changed.⁷⁴ Moreover, if anything, legal interpretation should be mandating retaliation awards accruing to the full expectation losses for the sake of truly re-establishing the *status quo ante* the breach. We conclude that nothing in the Agreement would prevent the DSB to deliberately discerning between the enforcement awards of tariff compensation and retaliation, and that a legal re-interpretation of the DSU would suffice to achieve this interesting outcome. However, re-interpreta-

73 MAVROIDIS (2000) says: “[B]y limiting the level of countermeasures (the procedural mechanism, it is worth remembering, to induce compliance with the WTO contract) to the damage done (rather than to the profit made) WTO Members might often not have an incentive then to comply at all.” We wholeheartedly agree, but contend that it is better to see countries not comply and compensate at a lower level than to have them not comply at all in the face of high overall levels of punishment and passively wait for retaliation to occur (or not). Making only retaliation awards “more expensive” to policymakers, as we suggest, is exactly apt to achieve former outcome. This might be second-best, but at least not the worst of all outcomes (p. 807).

74 Legal theory does not preclude re-interpretation or modification of existing rules, regulations or conduct. International public law states that so-called “silent modification” of a treaty or its interpretation is valid, if persistent state practice and *opinio iuris* are given. Silent modification has occurred with respect to Art. 27.3 of the UN Charter (MALANCZUK 1997 p. 375), for example. Re-interpretation of treaty language is equally possible and substantially easier. The only prerequisite is that the reinterpretation does not violate a peremptory norm of international law as defined in Art. 53 of the Vienna Convention on the Law of Treaties (1969) – an eventuality that could be safely ruled out here.

tion requires a change in mindset, and consent of all WTO Members. Otherwise states would accuse arbitrators of excessive judicial activism.

Obviously, our approach of making the instrument of compensation more attractive to policymakers, while at the same time discouraging the use of other instruments (or in the case of AD and CvD: rendering impossible), will still not help to overcome the biggest deficiency of the compensation regime: Compensation will remain a voluntary act and must happen at the consent of the violating party, in contrast to self-enforcing mechanism of retaliation. Proposals by academics of making compensation mandatory seem profoundly flawed (not to speak of financial compensation). Just as you cannot deny Members their option to escape the Agreements if domestic pressure is too high, it is equally impossible to make compulsory a measure that is inherently dependant on the consent and the co-operation of the party concerned. Policymakers will neither consent to an according reform nor yield to a potential verdict of that kind.⁷⁵

As noted before, we do not think that policymakers are malicious or hostile to the WTO system – they are just rational and choose the instrument that has the highest ratio of benefits and costs for them. Up to this very day policymakers' self-interest unambiguously has been biased towards AD/CvD action and violation-cum-retaliation. Remember, today compensation comes at the same economic price for considerably less value. Policymakers have constantly been discouraged to enact tariff compensation. We are convinced that under the proposed reform political decision makers for the first time ever would consider thoroughly the compensatory option. And, being faced with a new set of trade-offs that pits "cheaper" tariff compensation against awaiting more costly retaliation, chances are that policymakers deem it to be in their enlightened self-interest to comply.

In sum: By making the case for removal of quantitative equivalence between compensation and retaliation, we are suggesting to exert influence on policymakers' incentive structure. Without proposing politically still-born ideas such as mandatory (financial) compensation or a general prohibition to opt out of the Agreements (measures to be perceived akin to handcuffing and straight jacketing by any policymaker), without introducing punitive elements into dispute settlement, and without altering the

75 "Ultimately", as ROBERT HUDEC put it (2002, p. 82), "the compliance decisions of governments are determined more by calculated self-interest than by force."

systemic foundations of rebalancing and the profoundly economic logic of the “compensatory theory of countermeasures” (HUDEC 2002, p. 86), our proposal will confront recalcitrant policymakers with a trade-off worthy of close consideration. Whereas today in a DSB litigation the fall-back option for any violator concomitantly is also his most preferred option (i.e. embracing tariff retaliation, cf. fn. 27), this reform proposal raises the opportunity costs for accepting retaliation while lowering those of tariff compensation.

4.4 Discussion and area of future research

We admit that this proposal is not a panacea of WTO enforcement, that this reform agenda is open to criticism. We now address the arguments that we take to be most salient.

What to do in case of persistent rejection of compensation: This revitalization proposal cannot answer the ultimate question, which is „What needs to be done in case a country announces that come what may, it will neither comply nor compensate?” In such a case retaliation will have to be the ultimate enforcement means (the “last resort”, cf. Art. 3.7 DSU), and a true deterrent threat against this WTO perpetrator. Therefore, more effective retaliation regimes will have to be designed that are prone to effectively tackle the problems of current-day retaliation especially the bias against small countries and the lacking deterrent effect that the threat of retaliation poses to large injuring Members (as discussed in chapter 2). Reform of the DSB’s retaliation regime is an extensive field of research.

However, we indicate what we take to be the most promising directions of impact that could potentially lead to significant improvements of today’s underdeveloped retaliation regime. Among the most important areas of reform we see: i) cross-retaliation (see *supra*); ii) collective retaliation (where litigating parties may pool their retaliation rights in order to overcome the problem of constituting too small a market to cause noticeable pain to the perpetrator (cf. PAUWELYN 2000, p. 342; HUDEC 2002, pp. 86); iii) multilateral retaliation (where any economically powerful party can exercise tariff retaliation for a small player; cf. MAGGI 1999); and iv) auctionable retaliation rights (where the injured party is free to auction off retaliation rights against the Member in breach of a WTO Agree-

ment; cf. BAGWELL et al. 2003, and a recent proposal of the Mexican government; WTO Doc. TN/DS/W/40).

Gaining support of policymakers for the proposal: Reversing the perception of compensation so as to grant that enforcement mechanism a “preferential treatment” vis-à-vis that of retaliation, is crucially dependant on a successful mindset shift of policymakers and their subsequent support of the reform. Thereby, a lot hinges on the political-economic problems connected with offering compensation (instead of awaiting retaliation, as discussed in chapter 3.4). Compensation displays a direct effect when it comes to the political downside of a trade measure (import-competing sectors will be enraged by the threat of getting liberalized), yet an indirect effect with regard to the positive consequences. Retaliation, on the other hand, conveniently has it exactly the other way round. However, under our reform proposal, the compensation process is no longer “voluntary” (as Art. 22.2 DSU states). By integrating compensation negotiations into the official procedures of Art. 22.6 and 22.7 DSU the home government can make it clear to the public that there is a straightforward choice to be made: Either the country opts for liberalizing in an amount of Y US\$, or it faces tariff retaliation in an amount well above this sum. At this point we want to indicate that offering compensation does not only bear political downsides for domestic decision makers. First, the threat of compensation creates and invigorates constituencies in favor of compliance with the original DSB ruling and in opposition to the continuation of the protectionist measure. Suppose that a policymaker in the defendant country would like to seize a measure in violation of the WTO agreement. Sectors that are on a country’s “compensation list” (that is presented to the arbitrator by the losing country), now, will do their utmost best to pressure politicians into full and prompt implementation of a WTO recommendation and to sensitize public opinion about the matter. This domestic constituency against continuing protection can consist of domestic using industries, consumers, domestic importers of the protected goods, sectors on the “compensation list” and foreign exporters harmed by the protectionist policy in force.

Closely connected therewith, and second, is the situation, where a policymaker actually wants to liberalize, but is afraid of political repercussions by domestic import-competing lobbies. A publicly announced trade-off between less compensation and more retaliation may effectively help the politician to “lock in” trade liberalization (which is clearly beneficial to the economy as a whole and hence a viable long-term political strategy)

against the vehement opposition of domestic special interest groups that are able to exercise considerable immediate harm to the policymaker.⁷⁶

How to measure efficiency losses: Measuring expectation damages (that is direct trade damages plus efficiency losses) will be a tough call for WTO arbitrators: There is a stark information problem for them and a striking information asymmetry between the parties involved in a dispute. Unable to solve this problem *ad hoc*, we merely make the following remarks: First, restoration of expectation damages to the injured party is the legally, economically (and ethically) correct measure. It would be foolish to condemn the endeavor to quantify and monetize efficiency losses just because it is probably difficult to do so today.⁷⁷ Note that this task to the best of our knowledge has never before been tackled, so one just doesn't know how complicated this undertaking will prove to be. Second, coming up with adequate calculations of expectation losses at the end of the day is an inherently technical and empirical task: The WTO Secretariat and especially its Economic Research Department has an impressive track record in conducting economic analyses of WTO disputes and in calculating trade damages cf. KECK (2004); NEVEN (2000).⁷⁸ Third, we would like to point out that it is by no means impossible to come up with tangible figures for efficiency losses of the complaining party, since this is exactly what happens in tariff renegotiations under GATT Article XXVIII. There, "primarily concerned" countries negotiate and barter with the Member that asks to raise its agreed-upon tariff bounds. Tariff renegotiations involve compensation for actual trade damages and trade opportunities foregone in the future. Although parties thereby do not issue figures and numbers, the Members nevertheless come up with tangible results mirroring their assessments of expected harm done by the protectionist impact of a tariff bound increase.

76 This lock-in effect (or 'commitment approach'), by the way, is a frequent argument used when explaining, why states undergo trade liberalization agreements: Countries are thought to need external pressure in order to overcome powerful domestic special interest groups and to implement liberal trade policies which are in the interest of the general public, cf. (HAUSER/ROITINGER 2004, p. 642); STAIGER/TABELLINI (1999); or (BAGWELL/STAIGER 2002, p. 32) for an introduction.

77 As MAVROIDIS (2000) concurs: „The fact though that full recovery [i.e. expectation damages] is, in practice, sometimes hard to calculate, does not render the reparation exercise meaningless" (p. 769).

78 MAVROIDIS (2000, p. 769) notes: "Although assessment of damages is the task of the judge, calculation of the damage is essentially a quantification exercise, that is, essentially the task of the economist." The fact that the DSB makes too little use of the resources of its Economic Research Unit and puts too little effort in economic and econometric argumentation is a different story and one that can be reformed quite easily.

Voluntary compensation packages invite strategic gamesmanship: We proposed that Members in violation of the WTO shall be able to pre-select sectors that they would agree to liberalize. LAWRENCE (2003) warns that strategic gamesmanship on part of the violator might limit the value of concessions. For example, the US might commit to compensate by liberalizing its banana sector (which hardly exists), its typewriter industry (which does not have a competitive future anyhow), or its semiconductor sector (which happens to have no political clout with the current administration). We contend that it is erroneous to think that losing parties will propose liberalizing insignificant sectors. Rather, violators will make sure to open up exactly those sectors that are of great interest to the winning complainant(s). Remember that tariff compensation has to make up for the trade damage incurred by the complainant in money terms, and that it is granted on an MFN basis. In order to rebalance for a certain amount X US\$ in trade damages the compensating party will hurry to liberalize a relevant sector for the victim, because it wants to “fill up” its liabilities of X US\$ of trade damage as quickly and as efficiently as possible. If it chose a sector that plays a minor role in the bilateral trade relations between victim and perpetrator, the compensating violator would have to liberalize a lot in order to compensate for said amount. In that case the MFN effects on all the other countries will be significant, and uninvolved Members will gladly embrace the opportunity ample for free-riding on the compensating country’s commitments (cf. SCHWARTZ/SYKES 1996, p. 39).

Unaccounted externalities through compensation granted on an MFN basis: A last and indeed unresolved question is that of externalities that arise from “MFNed” compensation commitments. Taking into account the impact of permanent and multilateral compensation, the political costs of liberalizing are potentially very high. Due to the MFN requirement the convicted Member is obliged to also provide greater market access to all third countries. Thus, “the sum total will likely be higher than the ‘nullification or impairment’” (CHARNOVITZ 2002b, p. 631). We are not sure whether CHARNOVITZ’s assessment is correct and whether those compounded liberalization costs could actually be higher than the ones of facing retaliation (even considering our proposed exacerbation of retaliation). Could these costs even be so high as to be considered punitive?

Along the same lines is the following consideration that a successful complainant will engage in:

“Given ‘MFNed’ tariff compensation awards, how can we be sure to get fully compensated by the violating country with respect to our bilateral market access, if every Member gets the same tariff cut from the defendant? If the violating country lowers its external tariffs, will a third country “snatch” market shares that are supposed to be ours, or can we rely on the projection that the current trade pattern will continue after the tariff liberalization?”

Put differently: Whereas tariff retaliation against a small Member has a politically positive effect for a large country complainant, the consequences of multilateral compensational liberalization are dubitable, since the awarded indemnity might get partially frustrated by third-country exporters to the defendant’s market.

The issue on MFN and tariff compensation is academic virgin territory. To the best of our knowledge there exists no literature that has engaged in the political and economic MFN-induced externalities in the case of compensatory liberalization. We see this as a promising and exciting field of future research.

We are aware of the fact that with this reform agenda we are not only painting with a big brush, but are also arguing for profound changes of the WTO system and its dispute settlement regime. Given that the Doha Development Round is largely stalled and that not even the worst-needed DSB improvements are being tackled, viz. the overdue reform of the AD and CvD codes, chances for profoundly novel design and re-interpretation of dispute settlement seem scant. This, however, does not invalidate our conclusions. We hope to innervate trade professionals’ thinking of DSB reform and to expose promising areas of future academic research.

79 Thanks to USTR pressure, the Doha Declaration Article dealing with AD and CvD reform has largely one message, namely to keep the hands off any changes of the trade remedy regime. Article 28 reads in pertinent parts (emphasis added): “We agree to negotiations aimed at clarifying and improving disciplines under the Agreements on [safeguards] and on Subsidies and Countervailing Measures, while preserving the basic concepts, principles and effectiveness of these Agreements and their instruments and objectives.”

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