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## WTO dispute settlement procedure: Implications for a small country

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# **WTO dispute settlement procedure**

## **Implications for a small country**

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**Chris Nixon**

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2002

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**in association with the**

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# 1. INTRODUCTION

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## 1.1 What is international trade?

Amongst the rhetoric in the media coverage of the World Trade Organisation (WTO), it is often forgotten that it is businesses not governments that, to a large extent, engage and drive world trade.<sup>1</sup> It is businesses who identify opportunities in other regions and international trade is simply an aggregation of the fruits of those transactions on a national basis. For example, if a firm in Wellington sees an opportunity in Auckland, no one pays any attention. If the same firm sees an opportunity in another country to sell an identical good – politicians and other interested parties feel they have a right to comment on, become involved in, or even try to stop the transaction.

## 1.2 Why do governments intervene?

The key aspect of international trade is the cross border activity. Governments have a tendency to intervene in this trade. Reasons for government intervention include:

- as a way of raising government taxes. For some countries, with weak internal regulatory functions, taxing imports is one of the only methods of raising revenue.
- to protect industries against imports. New Zealand operated an import licensing scheme between 1938 and 1982 for expressly this purpose.
- to alter terms of trade. By restricting imports governments believe they can improve their balance of payments.
- achieve non economic goals. These include security and or foreign policy goals.
- restrict consumption of goods.

Hoekman & Kostecki (2001) p145 assert that:

*“Whatever the underlying objective, an active trade policy redistributes income by transferring resources to specific industries and the factors of production employed there, usually it does so in an inefficient and nontransparent manner, and for precisely that reason it tends to be supported by interest groups that lobby for import restrictions.”*

The types of interventions fall into three main areas:

- restrictions that increase the price of a good or services through a straight tax.
- quantitative restrictions that limit the volume of product that can be imported.
- barriers that impact on price and volume (usually non tariff barriers).

The WTO’s role is to help member nations attempt to self regulates international trade by reducing trade restrictions. By reducing trade barriers countries believe that economic growth is likely to be stimulated.

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<sup>1</sup> A segment of world trade that is not often analysed is intra company trade, where trade between different subsidiaries of the same company in different regions are trading with each other. This part of world trade is growing rapidly.

### 1.3 What is the significance of trade for a small country?

Most small countries depend on trade for their standard of living. Unlike large countries they do not have a large internal market from which economic activity can support a high standard of living. New Zealand is a prime example of this with exports at approximately 37% of GDP, NZIER (2002).

Unfortunately for New Zealand, its major source of wealth creation – agriculture – is subject to the harshest importing restrictions, relative to other major trades. For example, the average tariff on manufactured goods is roughly 4%-5%. The average tariff on world agricultural goods traded is close to 40%. Governments tend to focus interventionist policies on the domestic agricultural sector. The outcome of this process is that imports are restricted and world agricultural trade is heavily managed.

### 1.4 Why are trade rules important?

International trade involves risk, particularly when governments (both in the importing and exporting region) can arbitrarily impose restrictions on the flow of trade. Not only is international trade risky (relative to domestic trade) but also the considerable investments that support the trading infrastructure are also at risk. The involvement of government in an arbitrary fashion not only constricts trade it also precludes further development of that trade (opportunity cost foregone of further trade).<sup>2</sup> Therefore exporters, from small countries, who are least able to influence world trading rules have strong incentives to support a liberalised rules based trading system.

The impetus for a rules based system has its roots in the failed international organisations and international trading chaos that preceded World War II. The “*beggar thy neighbour*” policies that it encouraged, and the disastrous economic consequences of World War II generated the conditions for international action. It persuaded “large nations”, particularly the United States, to put aside their protectionist tendencies and push for an international agreement that set rules on trade. The GATT and the its successor organisation the WTO are the result of this process.

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<sup>2</sup> This trade “dynamism” is often over looked, however it is the dynamic nature of trade that may have a more important long-term impact on growth and incomes.

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## 2. THE INTERNATIONAL TRADING SYSTEM

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### 2.1 GATT

Reaching agreement to form the GATT was not straightforward. In 1948, the Havana Conference set up the International Trade Organisation (ITO). However, the United States Congress refused to ratify the Agreement, in effect rejecting the formation of the ITO. By default, a treaty that was part of the ITO, the General Agreement on Trade and Tariffs (GATT) became the vehicle for international agreements on dismantling trade barriers. Governments joined the GATT as contracting parties rather than members – the GATT was a treaty between contracting parties not an international organisation.

The successive GATT agreements dealt exclusively with trade in goods and had a primary focus on border barriers and ways of reducing those barriers. It was only with the Tokyo Round (1973-1979) of GATT negotiations that an effort was made to go beyond the traditional concerns of tariffs on industrial products.

The GATT represented a balancing act between the need to engage in international trade and to protect domestic interests. New Zealand, for example, initially paid the GATT cursory attention, even signing the New Zealand Australia Free Trade Agreement (NAFTA) which was contrary to GATT principles in 1965. It was not until New Zealand started to dismantle its industrial protection that GATT became a serious trade policy issue in New Zealand. It was only at this point that New Zealand's domestic and international objectives lined up with the GATT process.

The GATT (and now the WTO) can be viewed as a long-term process that has gradually increased the costs of maintaining or increasing various forms of protection by:

- increasing the scope of activities covered by GATT disciplines (e.g. extending coverage to agriculture and services), and
- tightening up on disciplines that already exist (e.g. the move to a stronger disputes settlement regime).

The aim of this process has been to reduce the costs to businesses of international trade.

The GATT has been successful in its narrow focus of lowering tariffs on industrial products. This has brought major benefits to the world economy as it:

- increased trade growth and incomes.
- increased the certainty of international trade and a surety of the trading infrastructure.
- improved the technology in transport and packaging.
- improved financial instruments that support trade.

The advancement of technology in the form of computing power and the transfer of electronic documentation is also having a significant impact on trade. The combined result is increasing the interconnectedness of the world. However, up until the Uruguay Round, GATT had little impact on sectors such as agriculture and services.<sup>3</sup>

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<sup>3</sup> While the Tokyo Round attempted to introduce these topics, the impact on world trade was negligible.

## 2.2 The Uruguay Round

The increasing complexity of world trade, the growth in non traditional trade areas (such as services and agriculture), and the reduction in tariffs that exposed a multitude of domestic regulations that restricted trade meant that a new form of process was required.

The GATT was also a victim of its own success. The GATT, which used a “club” model approach was suited for a membership of 40 – 50, it was not designed for a 120-170 members. Furthermore, the GATT organisation was expected to carry out the functions of the ITO. To some degree, the Uruguay Round formalised this position by creating the World Trade Organisation (WTO). The WTO is an international organisation that oversees and administers multilateral trade agreements negotiated by members. This includes:

- GATT: which examines goods.
- GATS: which examines trade in services.
- TRIPs: which examines intellectual property rights.

The WTO only looks at relationships between governments. It monitors the regulatory actions of governments in the area of trade. It does not have any jurisdiction over individual businesses that create trade.<sup>4</sup>

## 2.3 The multilateral system

The world has no central governing body to co-ordinate relationships between states, therefore any international co-ordination requires a degree of co-operation between states and a degree of facilitation. The WTO, for reasons already canvassed, is a creation of member states. Its aim is to facilitate mutually agreed trade co-operation between member states. Its role is defined by Krasner (1983) as:

*“sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors’ expectations converge in a given area of international relations”*

While countries monitor each other’s compliance with the “explicit principles, norms and rules”; the multilateral system depends almost entirely upon self-regulation. Since 1947 the world trade system, while perhaps not selling it this way to the domestic actors, has relied almost exclusively upon self interest to enforce the mutually agreed principles.

Of major importance to the functions and operations of the WTO are:

- the role of the WTO in facilitating dialogue between members. The WTO, to facilitate the negotiation process, depends on a mutually agreed upon code of conduct to reach an agreement and enforce that agreement.
- each member brings a different mix of attitudes, interests, and ideas to a negotiating process, in the same way as individual buyers and sellers interact in a market.

For small countries, the focus is on the rules of the “multilateral market”, since they have little market power, particularly on a bilateral basis with bigger nations and little to gain from imposing trade barriers (see Nixon and Yeabsley (2002)).

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<sup>4</sup> Although it has found fault with payments (subsidies) made to individual firms by a member government.



Big countries, with sizeable markets leading to significant market power, are in a position to be able to restrict imports and impose their will on smaller countries to increase their own economic welfare. World growth, however, could only fall with the imposition of trade barriers by a big country since it restricts specialisation and its economic benefits.

The Uruguay Round, while not the first attempt, was partially successful in its attempt to restrict the protectionist tendencies of larger countries. Part of this process was the formation of the Disputes Settlement Procedure (DSP).

## 2.4 Changes in dispute settlement

“The Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations”, signed by ministers in the Moroccan city of Marrakesh in 1994 contained 15 agreements spelling out the results of negotiations started in Uruguay in 1986. Some have argued (e.g. Hoekman & Mavroidis, 1999) that one of the main results of the Uruguay Round was the strengthening of the dispute settlement procedure. The aim of the dispute settlement procedure is make the dispute settlement process more automatic and reduce the scope for defendants to block the adoption of reports. Key changes from the GATT to the WTO are shown below in Table 1.

The dispute settlement process arises when one member country believes that another member country is taking an action that is inconsistent with the provisions of the WTO. Overseeing this process is the Disputes Settlement Body (DSB) (see Appendix A and B for the panel process and a description of the relevant Articles). As the sole authority to establish a panel the DSB can accept or reject either the panels’ or appeal board’s final report. Only if the DSB rejects the panels’ recommendations are the findings not adopted.<sup>5</sup> The DSB monitors the implementation of the rulings and recommendations, and has the power to authorise retaliation.

**Table 1: Key changes in the dispute settlement procedure**

GATT	WTO
While it operated for nearly 50 years, the GATT was a temporary organisation.	The WTO is a permanent organisation.
Fragmented dispute settlement mechanism with both the GATT and the Tokyo Round agreements both having their own dispute settlement regime.	The establishment of one single dispute settlement regime under the DSB.
All parties had to agree before disputes were resolved.	Panel makes the decision, consensus not required between parties.
Panel results were not binding.	The DSB makes a binding decision.
	Precise rules to encourage the implementation of panel rulings.
	Establishment of an Appellate Body made up of seven recognised experts.
	The DSB had increased monitoring power to enforce rulings.

Source: NZIER

<sup>5</sup> It is very rare for the DSB to reject a panel’s final report.

Once the necessary processes have been undertaken, e.g. arbitration on compensation has been completed, and either accepted or rejected by the parties involved, the Panel, depending on the outcome of the arbitration, can recommend the extent and amount of retaliation.

## **2.5 Issue associated with settling disputes**

A number of factors need to be considered when taking cases to the WTO panel. These are discussed below.

### **2.5.1 Only governments have standing**

Individual sector groups or firms can not bring a case directly at the WTO. They must first lobby their government, who, if they decide to take on the case, will initiate the first consultation. In effect, the government acts as a filter, vetting industry complaints and deciding which cases, it will take further.

By “controlling” what cases are brought to the WTO, governments weigh up:

- the likelihood of success. In most cases, governments would have more expertise than the private sector when assessing whether or not they will succeed in any particular case.
- the state of the relationship between the countries concerned. A government, wishing to maximise its long-term strategic aims is in a better position to make judgements on whether or not a case should proceed.

Levy and Srinivasan (1996) have developed a simple model to demonstrate that allowing private companies to petition the WTO directly is not welfare enhancing. A government that is welfare maximising has to consider more than one specific case. According to Levy and Srinivasan (1996), allowing companies to directly approach the WTO will have negative returns since trading partners do not see specific trade issues in isolation from one another. Removing the filtering process, which allows governments to be gatekeepers to the WTO, would make it difficult for governments to fulfil their trade negotiation commitments. Limiting actions to governments ensures that sectional interests can not hijack the process.

### **2.5.2 Increased information requirements**

Levy and Srinivasan (1996) also point to the need for governments to have full information about the extent and diffusion of costs and benefits of any particular action. This is particularly interesting in the case of New Zealand and Australian lamb exports to the United States (see section 3.2.3) were it is possible that initial forecasts of the losses to New Zealand were overstated.

The New Zealand government has estimated the costs of the US actions to the New Zealand industry at NZ\$20 million (Ministerial Announcements, 15<sup>th</sup> June 2001). While no methodology is attached to this figure, it is presumed that it is a naïve forecast of volume at a notional price of meat not sent into the US market.

However, Paarlberg & Lee (2001) using a partial equilibrium model demonstrate that it was possible that New Zealand producers and exporters (along with US processors) may have captured rents over and above what they could have achieved given the regime that existed before 1999. Paarlberg & Lee (2001) suggest that consumers and lamb producers lost out in the US because of the strategic games played by processors when tariff-quotas were binding. This is supported by price data produced since the tariff-

quota was imposed, showing that prices have risen to consumers but shown “little difference” (in nominal terms) for US growers.<sup>6</sup>

### 2.5.3 Possible lessons

Traditionally, in New Zealand, empirical models have not been important in the development of policy or been used in business. There was a consensus that trade liberalisation was good for the economy and did not require this type of sophisticated analysis. This has changed because:

- while the majority of people vote for political parties that support trade liberalisation, there is a small vocal minority who are opposed to trade liberalisation in New Zealand. The impact of changes to the trading environment need to be demonstrated to a wider audience than previously had no knowledge of or required little knowledge of trade liberalisation (both in an *ex-post* and *ex-ante* form). It can no longer be taken for granted that the vast majority of New Zealanders support trade liberalisation therefore the costs and benefits need to be clearly demonstrated to the public.
- the aim in the Uruguay Round was to widen the scope of sectors covered by trade rules. In this context, the need for sophisticated analysis was not required i.e. New Zealand would benefit. As the lamb case shows (with conflicting analysis and different degrees of sophistication associated with each analysis), who gains from a particular set of trade policy actions may not be clear-cut. Therefore, analysis needs to be undertaken before policy is fully formulated.

### 2.5.4 The tactics of initiating a case

Being “right” in any particular trade dispute is not necessarily the most important factor when taking a case to a WTO panel. As well as weighing the costs and benefits of taking another nation to the DSP (see previous section), small countries need to ensure that tactically they have a sound approach to the panel process. Factors small countries need to consider include:

- suggesting to the panel specific recommendations for how a country should remedy the situation that has arisen. This may avoid the stalling tactics used by governments that have been found guilty of violations. Hoekman & Kostecki (2001) p88 point to the Banana case (see 3.2.1) as an example of the EU deliberately stalling for time.
- the amount of time taken for the panel process to work through cases can discourage private sector and government to seek rulings. Cases can take up to two and a half years to be completed.
- cases do not normally involve financial compensation for damages incurred or financial penalties.

### 2.5.5 Enforcement

The basic problem with the trade remedies available is that they restrict trade, which is counter to the WTO philosophy. However, the repeat game nature of trade means that solutions have to be found. Therefore moral persuasion, i.e. follow the rules, becomes a much more potent instrument in the WTO. Countries have a stake in following the rules since they would like to benefit out of world trade as well.

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<sup>6</sup> The growers were the group that the tariff-quotas were designed to protect.

For small countries, taking cases to the WTO is a serious matter. Even if they succeed in winning their case, there is a matter of enforcement of the rules. As Nixon and Yeabsley (2002) describe, putting up trade barriers against a trading partner by a small country, as part of any settlement, will be detrimental to that country i.e. it stifles trade. Small countries have to think carefully about what they want from a “successful” outcome and how the post decision trading affects their national interest.

Despite the lopsided nature of trade power, the system has worked well for the most part. In the recent lamb case, small countries (Australia and New Zealand) have taken a larger country (US) through the disputes settlement procedure and won. This increases the confidence in the rules in small countries and makes them willingly partners in WTO process.

However, in some cases such as the hormones case the use of retaliation has not worked and other types of instruments need to be investigated. Hoekman & Kostecki (2001) suggest that rather than retaliation, countries should look to negotiate further concessions out of countries who are found in violation of the rules.

Another issue is the amount of retaliation a small country can deliver may have little effect on a larger country deemed to have broken rules. Buckingham et al (2001) has suggested that groups of countries (or all of the WTO) could retaliate. In this way the costs by the offending party would be much higher than if one small country retaliated.

#### **2.5.6 Resource costs**

Small countries and developing countries, by definition are resource constrained. Contrast this with larger countries that have the ability to access legal expertise, collect data, and a world-wide network of diplomatic representation to feed relevant information into preparing a case.

The WTO secretariat is mandated to help nations prepare cases, but the reality is that the resources the secretariat has are very limited. For developing nations and smaller nations to participate more fully in the WTO process, particularly the disputes settlement process, will require more international resources. This is not easy to achieve since the source of those funds comes from larger countries.

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## 3. CASE STUDIES

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### 3.1 Overview of case results

For the most part, the settlement procedure has worked well, with the majority of cases being settled before going to a panel (see Table 2).<sup>7</sup> While the WTO has no power to force countries to conform to its rulings and relies on countries to “play the game” only a few cases have caused major trade disruption.

The more pertinent characteristics include:

- the DSP is capable of exerting substantial discipline over the design and implementation of a region’s trade laws. *“In short, the agreement has teeth” Gascoine (2000).*
- most cases have involved the EU and US as either a prosecutor or defendant.
- approximately 25% of cases have been against developing nations.
- developing nations have successfully opened proceedings against the US (notably Costa Rica on US restrictions on cotton textiles)
- the majority of cases have been settled without the need for arbitration.

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**Table 2: WTO Cases**

Between 1<sup>st</sup> Jan 1995 and 2<sup>nd</sup> May 2001

	Number
Complaints notified to the WTO	231 (178 of which involve distinct matters)
Active cases	15
Appellate Body and panel reports adopted	49
Settled or inactive cases	37
Active cases on implementation of WTO rules	5
Adopted Appellate Body and Panel Reports on Implementation of WTO rulings	6
Active arbitrations on level of suspension of concessions	2
WTO authorisations of suspension of concessions	5

Source: WTO

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Despite the WTO’s success, there are areas of concern. Of particular interest are the cases that involve the EU and the US, since it is those two trading entities whose behaviour will decide the success or otherwise of the multilateral system. In the past, they have been able to dictate (with eyes firmly fixed on domestic politics) the structure of world trade.

We have picked three controversial cases involving the EU and US and one case involving the US and Australia and New Zealand to illustrate the issues involved.

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<sup>7</sup> Although the precise number of cases that do not reach panels is not known.

## 3.2 Selected case studies

### 3.2.1 Bananas

#### a) *The issue*

The banana dispute has its origins in the disastrous selling conditions in European markets in 1992. The market was flooded with subsidised European summerfruit, depressing prices not only in Europe but also around the world.<sup>8</sup> To prevent a similar problem European regulators decided to limit imports of certain fruit. For bananas, the EU introduced a system of quotas that promoted imports from former colonies (African, Caribbean, and Pacific countries) and discriminated against others (mainly South American countries). The South American production was shipped and marketed in Europe by US companies (Dole and Chiquita).<sup>9</sup>

#### b) *The case*

On behalf of the Latin American growers, the US took the banana case to the WTO. The first ruling was made under the pre Uruguay Round rules. The GATT panel ruled that the regime, instituted in 1993, transgressed GATT obligations. The EU, under the consensus orientated rules of the GATT, were able to block the adoption of the ruling by the full GATT.

In 1996, now under WTO rules, the United States along with Ecuador, Guatemala, Honduras, and Mexico challenged the EU banana regime and took the EU to the WTO. In 1997, the WTO panel ruled that the European import regime violated its WTO obligations under the General Agreement on Trade in Services (GATS).

#### c) *The outcome*

After the WTO Appellate Body upheld the panel ruling, the EU was given until 1<sup>st</sup> January 1999 to comply with the ruling. When the deadline expired, the EU implemented a slightly modified version of the banana importing regime that did little to address the ruling issued by the WTO.<sup>10</sup>

The DSB authorised US retaliatory tariffs amounting to \$US191.4 million per annum. Tariffs were applied to European luxury goods such as Scottish cashmere sweaters and Parma ham.

In April 2001 the US and EU agreed to a new regime for importing bananas into the EU. The mix of tariffs and quotas instituted in 1993 will become a tariff-only regime by 2006. In the transitional period companies will receive licences to fill quotas based on their volumes in 1994-96.

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<sup>8</sup> For New Zealand kiwifruit growers, whose main market was Germany, returns in 1992 were very poor.

<sup>9</sup> The European Union has tried to portray this case as big US multinationals taking on poor states of Africa, Caribbean, and the Pacific. It has played down its attempts to press these ex-colonies to sign “partnership” agreements in which European companies would corner their markets (Economist, 1999)

<sup>10</sup> Despite some evidence that New Zealand may have gained from the ban!

### 3.2.2 Beef hormones

#### a) *The issue*

The hormones dispute has its origins in the 1980s when the European Union (EU)<sup>11</sup> became alarmed about the use of hormones domestically. The EU banned the use of hormones by domestic producers and also banned the imported products that used hormones. Both Canada and the United States complained to the WTO that the EU had reneged on its obligations under the Sanitary and Phytosanitary (SPS) Agreement. The EU directives applied a zero tolerance policy to six hormones. These were:

- the naturally occurring hormones: oestradiol-17 $\beta$ , progesterone, and testosterone.
- the synthetic hormones: trenbolone acetate, zeranol, and melengestrol acetate (MGA).

#### b) *The case*

This effectively banned North American beef from Europe, since most beef produced in North America is treated with hormones.

When this case was heard, the Appellate Body ruled against the EU, because the measures were not based on “sound science”, i.e. since the measures were not based on the appropriate risk management assessments.<sup>12</sup> In effect, the risk assessment demonstrated that the ban by the EU was irrational and the EU authorities had failed to connect the EU directives with its international obligations under the SPS Agreement. Furthermore, the panel found that:

*“no evidence was presented to substantiate a claim that any of the six hormones were being improperly administered on a widespread basis.” Buckingham (2001) et al p6*

At that point, the Appellate Body recommended that the WTO request the EU to end the ban so that the SPS Agreement obligations are met.

#### c) *Outcome to date*

While the ruling was seemingly straightforward the legalistic nature of the WTO meant that the recommendations were subject to interpretation by all parties associated with the dispute. A description of the relevant stances and sequence of events include:

- the EU informed the WTO that it could take up to four years before the measures could be realistically put in place.
- the US and Canada argued that the appropriate measures could be undertaken within ten months.
- in May of 1999, the WTO arbitrator ordered the EU to comply within 15 months.
- the EU has not complied with lifting the ban on hormone treated beef or produced and evidence that justifies the ban under the SPS Agreement.

To-date, there is no progress on lifting the European ban on hormone-treated meat. The US has retaliated with US\$117 million per annum punitive tariffs.

This case is most worrying because no agreement seems to be in sight. Informally, it has been suggested that one of the reasons the EU refuses to comply is that it causes extra

<sup>11</sup> Formerly called the European Community (EC).

<sup>12</sup> For MGA no risk assessment has been done. In regard to the other five growth hormones all were considered safe as long as they were used correctly.

strain on the farm subsidy budget. Allowing imported meat to contain hormones means that EU farmers would also be allowed to use hormones. The greater volume of meat produced would increase the support payments to EU farmers under the Common Agricultural Policy.

As with the bananas case, domestic subsidy induced supply in the EU has caused international trade disputes.

### 3.2.3 New Zealand/Australia lamb case

#### a) The issue

The lamb case differs from the other three cases in the respect that it is two small to medium sized countries (New Zealand and Australia) taking a larger country (US) to the WTO. The issue revolves around lamb imported into the US. The US Government through the United States International Trade Commission (USITC), citing domestic price concerns by sheep farmers imposed levies on imported Australian and New Zealand sheepmeat. Supposedly, this was to halt the rapid rise in sheepmeat being imported from these two nations.

#### b) The case

New Zealand and Australia took the US to the WTO under Article XIX of the 1994 GATT Agreement and Article's 2 and 4 of the Agreement on Safeguards. According to Buckingham et al (2001) p8:

*“The case involved a narrow point of law and administrative action – did the United States International Trade Commission (USITC) get it right when it levied a safeguard measure against the incoming tide of New Zealand and Australian lamb meat?”*

The Panel decision has found that the USITC had contravened the Agreement on Safeguards. Specifically, the Panel ruled:

- there was insufficient evidence to demonstrate that increases in sheepmeat imports into the US were “unforeseen developments” as stipulated by Article XIX of GATT 1994.
- the USITC had failed to define the domestic industry that was being injured by imports and failed to produce documentation demonstrating that the safeguard request had come from producers representing the total domestic production.
- that while the method of investigation was approved, including the investigation of factors that contribute to the threat, the USITC failed to demonstrate the link between increased imports and injury or the threat of injury to US sheepmeat producers.

#### c) The outcome

With the panel finding favouring New Zealand and Australia, the US agreed to drop the tariffs. This victory has demonstrated the worth of the WTO in the eyes of politicians and the New Zealand public giving greater credence to the WTO.

### 3.2.4 Foreign Sales Corporation (FSC)

#### a) The issue

In 1971, the US government enacted the DISC legislation, which provided a special tax exemption for exports. The EU challenged the DISC legislation in the GATT, alleging



that it constituted an export subsidy because it resulted in exports being taxed at lower rates than comparable domestic transactions. In 1976, a GATT panel ruled against the DISC legislation and against some other European nations (Belgium, France, and the Netherlands), finding that in all cases they taxed exports more favourably than comparable domestic transactions.

This was a stalemate. Both the Europeans and United States refused to accept the findings of the panel. To break the impasse in 1981 an “Understanding” was adopted by the GATT Council. The “Understanding” – elements of which were incorporated into the Tokyo Round Subsidies Code – provided that countries did not provide an export subsidy when they refrained from taxing foreign sources of income, even if this resulted in exports being taxed more favourable than comparable domestic transactions. The Europeans took this to mean that the “Understanding” overruled the 1976 GATT panel and favoured their methods of export tax exemptions. The US then used the “Understanding” to reformulate their legislation to maximise the benefits of export-enhancing exemption method. The result was the FSC legislation.

***b) The case***

The Europeans, under WTO rules in the 1990s, have challenged the FSC legislation. The WTO Panel and the Appellate Body ruled that the FSC legislation exempted income from taxation that would have otherwise be due under general US taxes. This was justified by Article 1.1 of the Agreement on Subsidies and Countervailing Measures (SCM) which states that a subsidy exists if: “government revenue that is otherwise due is forgone or not collected.”

***c) Outcome to date***

At the time of writing the WTO has decided to delay its interim ruling on the legality of the FSC legislation – the ruling will find fault with the US law. Meanwhile the European Commission has threatened to impose \$4 billion a year punitive tariffs on US exports if the US fail to agree.

This case involves a high degree of risk for the world trading system. The scale of retaliation threatened, case characteristics (e.g. sovereignty issues), and its long running nature makes this an important test case.

**Table 3: Cases analysed**

<b>Case</b>	<b>Complainant V Defendant</b>	<b>State of negotiations</b>	<b>Potential for Trade disruption?</b>
<b>Bananas</b> (1993-1999)	US and Latin American countries. V EU, African, Pacific, and Caribbean nations.	Settled. The US and EU have agreed to a new regime after the third ruling against the EU.	NA. Although the EU set a dangerous precedent by continually ignoring WTO decisions.
<b>Beef hormones</b> (1985-88 ban imposed. 1996 US takes the EU to the WTO.)	US V EU.	Continuing dispute. EU has ignored WTO rulings. US have responded with retaliatory tariffs.	Medium. The EU has refused to engage in any meaningful way.
<b>Lamb</b> (1999 – 2001)	NZ and Australia V US.	Panel found in favour of Australia and NZ.	Low. Australia and NZ may have gained despite the tariff-quota.
<b>Federal Sales Corporation</b> (1971 - ?)	EU V US.	A panel has found in favour of the EU however the final decision has been delayed.	High. This goes to the heart of the US regulatory system.

Source: WTO & NZIER

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## 4. CONCLUSIONS

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### 4.1 The DSP: impetus or roadblock?

The history of the multilateral process has been one of slow progress towards reducing trade barriers. Part of this process has been the setting up of a rules based system to govern international trade. It is too early to say whether the DSP will provide a sustainable solution for settling international trade disputes over the long run, although it is off to a promising start.

A potential reason for the DSP's early success is that international trade relations require repeat engagement between nations, in particular, the actions of the two main players; the EU and the US. What actually convinces countries to act in accordance with WTO rules is that they want to benefit from freer trade as well, although this is not always made clear by governments to domestic actors who are opposed to freer trade.

Below we discuss some of the issues that smaller countries and developing nations need to factor into the equation before taking a case through the DSP process.

#### 4.1.1 Path dependence

The EU and the US have dominated the proceedings of the GATT by virtue of their strong economic position in the world economy. As a general rule, if both of these trading blocks disagreed with a ruling, it would be difficult to see how that ruling could gain support. Equally, if the EU and US agreed upon a ruling it was difficult to see how it would not become part of the multilateral process.

The major problems, therefore, will occur between the US and EU, where each side is determined to "hold the line" in a particular trade dispute. No world trade policeman exists to sort and make rulings on these problem cases, therefore the risk remains that the EU or the US may prefer to act unilaterally. The use of arbitrary power would have major implications for the world trading system, with the likelihood of further protection and trade wars akin to the 1980s.

Despite this, the cases reviewed show that the case settlement is working relatively well. While some point to the delays in resolving cases (Butler & Hauser, 2000) as being a problem, the dispute settlement procedure has not broken down.

For small countries and developing nations, there is some room for cautious optimism that the system will hold together. With a more effective dispute settlement regime, relative to the pre 1994 GATT system, small countries can participate and be more effective in enforcing international trading rules e.g. NZ/Australia lamb case taken against the US.

#### 4.1.2 Costs

The costs and expertise required do not come cheaply. Unlike smaller and developing countries the major WTO players are:

*"well equipped with legal talent, are well briefed by export interests, and have a worldwide network of commercial and diplomatic representation that feeds their systems with relevant data." Hoekman & Mavroidis (1999) p6*

Should smaller and developing countries qualify for financial help? Unfortunately, this raises another difficult question about who should pay for these countries to develop

and sustain trade law expertise, particularly if those that pay for developing countries to improve their capability find that this expertise is used against them in WTO panels.

#### **4.1.3 Enforcement provisions**

While the DSP has been working relatively well, it has not stopped countries from putting up trade barriers. One of the issues is credible threats. If a large country does not comply with a recommendation, the only option is trade-restricting punishment which could reduce both countries welfare. Moral persuasion is the only pressure that can be bought to bear on a large nation that transgresses.

For nations that have been highly involved in international trade policy, particularly agricultural trade policy, moral persuasion does have some resonance – these nations have been through damaging trade wars in the 1980s and realise that protection costs everyone.

However, the challenge now presents itself to persuade developing countries and countries that have not been part of the world trading system (e.g. Russia and China) that it is in their own interests to adhere to international trade rules – particularly as they become an increasingly important part of the world trading system.

#### **4.1.4 The need for empirical work**

Trade disputes are becoming more complicated. This is particularly so in agriculture where tariff barriers average roughly 40%. In this type of market, the actions of government authorities, processes, farmers, and competitors can change profitability for other players in ways that you would not expect from economic first principles.

This occurred in the US lamb case where the process and importers were able to gouge the US consumer and domestic US farmer (see Paarlberg & Lee, 2001). In this situation, should have New Zealand and Australia bothered to take the US to the DSP?

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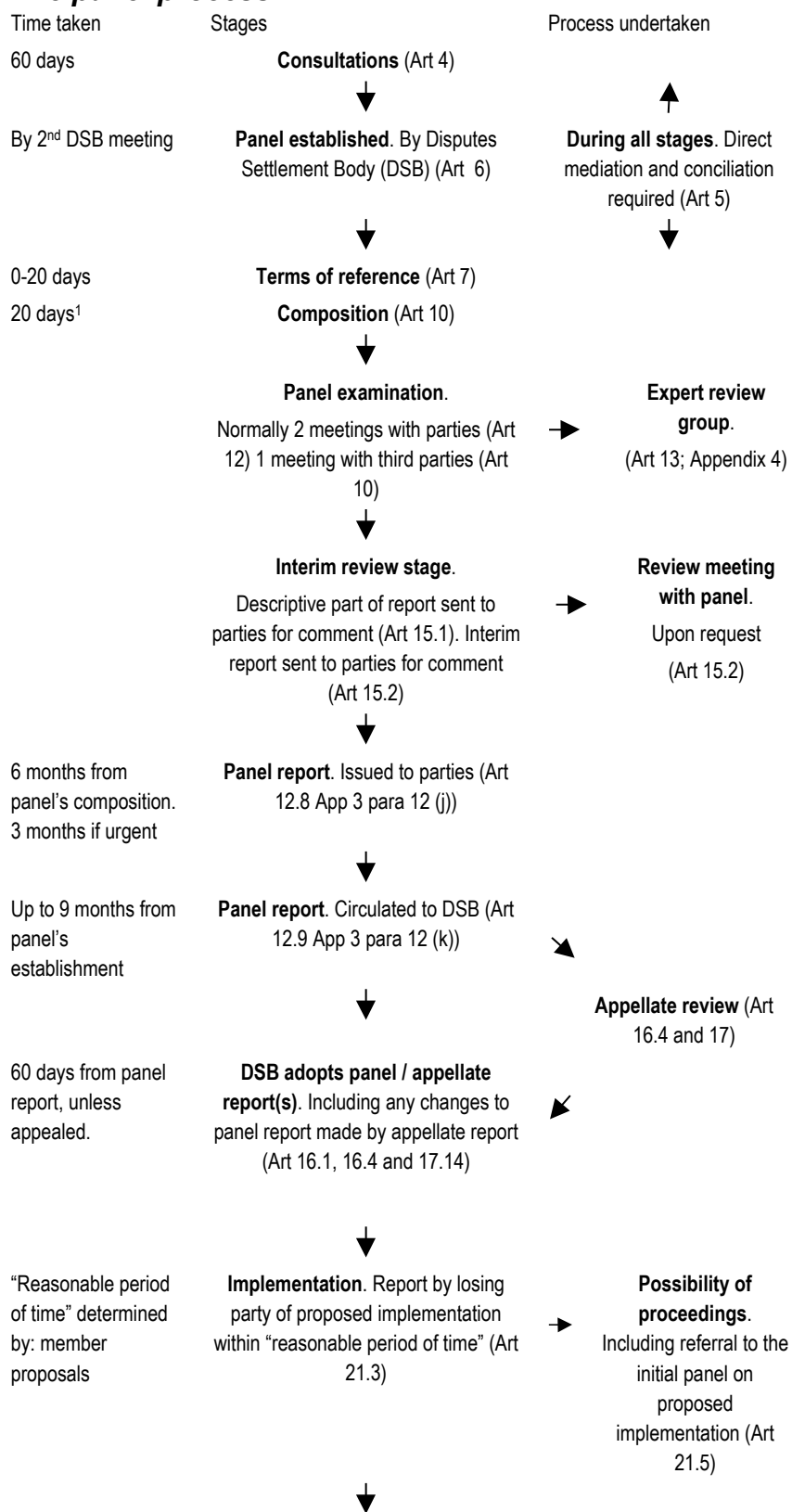
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# APPENDIX A: THE PANEL PROCESS

## The panel process



**In cases of non-implementation.**  
Parties negotiate compensation  
pending full implementation (Art 22.2)

***The panel process (cont)***

↓  
**Retaliation.** If no agreement on  
compensation, DSB authorises  
retaliation pending full implementation  
(Art 22.2 and 22.6)



**Possibility of  
arbitration.** On level of  
suspension procedures  
and principles of  
retaliation (Art 22.6 and  
22.7)

↓  
**Cross-retaliation.** Same sector, other  
sectors, other agreements (Art 22.3)

Notes: (1) 10 if director-general asked to pick panel.

Source: [www.wto.org](http://www.wto.org)

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## APPENDIX B: DSU PROVISIONS

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The rules and procedures of the DSU apply to disputes arising under any of the MTAs, including the WTO Agreement and the DSU. They also cover disputes under the PTAs, where the parties to the PTA have agreed to apply the DSU. The rules and procedures in the DSU apply subject to any special or additional dispute settlement rules and procedures set out in the WTO agreements. For example, in the Agreement on Subsidies and Countervailing Measures, there are specific dispute settlement provisions that prevail, in the event of a conflict, over the more general provisions of the DSU.

A Dispute Settlement Body (DSB) is established to administer the dispute settlement system under the WTO agreements. Specifically, it has the authority to establish panels, adopt panel and Appellate Body reports, maintain surveillance of implementation of rulings and recommendations, and authorise suspension of concessions or obligations.

Article 3 recognises that the dispute settlement system of the WTO is a central element in providing security and predictability within the multilateral trading system, and that it serves to protect the rights and obligations of members by clarifying and interpreting the provisions of the agreements. The DSU emphasises that while the dispute settlement rules and procedures are meant to clarify the agreements, the rulings of the DSB cannot add to or diminish the rights and obligations provided in those agreements.

Article 3 incorporates the basic GATT objective of achieving a mutually acceptable resolution of a dispute among the parties. Where a mutually agreed resolution cannot be achieved, the objective is to secure a withdrawal of the measure found to be inconsistent with a particular agreement. Compensation should be resorted to only if withdrawal of the measure is impractical, and then should only be temporary. Suspension of trade concessions or other obligations, i.e., retaliation, is only to be used as a last resort, and then only in certain defined circumstances.

Article 4 sets out the rules and procedures governing consultations. A complaining party must seek consultations with the defending party, before making a request that the DSB establish a panel to hear the dispute. Generally speaking, a complaining party must wait sixty days after making a request for consultations before requesting establishment of a panel. Members are encouraged to use consultations in order to obtain a mutually acceptable resolution of the dispute. Another member may join in the consultations, where that member has a substantial interest in the subject matter of the dispute.

Article 5 provides for procedures to resolve disputes voluntarily through good offices, conciliation or mediation. These are entirely voluntary procedures that depend on the willingness of the parties to the dispute to utilise informal mechanisms to achieve a mutually acceptable resolution of a dispute. Procedures for arbitration are set out in Article 25.

Articles 6, 7 and 8 provide the mechanisms for the establishment, terms of reference and the composition of panels. A complaining party has an automatic right to have a panel established, after 60 days have expired from the day consultations were requested with the other party. Since 1988, dispute settlement panels in the GATT have had standing terms of reference. This provision is incorporated into the WTO, providing that a panel is to examine, in light of the relevant provisions of the WTO agreements cited by the parties to the dispute, the matter referred to the DSB and may make such findings as provided for in those agreements. Specific terms of reference may be established where the parties to the dispute agree.



Article 8 sets out the general GATT practice requiring that panels be composed of well-qualified governmental or non-governmental persons who have demonstrated a certain expertise in international trade law or policy. Citizens of governments who are parties to the particular dispute may not serve on a panel, unless the parties to the dispute agree otherwise. Panels are generally composed of three panellists. The WTO Secretariat proposes nominations for the panel to the parties to the dispute, and generally speaking, the parties agree on the persons who will sit on the panel.

Article 11 sets out the function of panels which is to make an objective assessment of the issues before them, including a determination of the facts of the case and the applicability of specific rules under the relevant WTO agreements, in order to make such findings as will assist the DSB in making the recommendations or rulings necessary to resolve the dispute.

Articles 9 and 10 provide specific rules and procedures for dealing with multiple complainants and third parties. There is a strong preference in the DSU to have a single panel hear complaints from several parties to determine the same issue at the same time. Article 12 and Appendix 3 of the DSU set out detailed panel procedures.

Article 13 provides a panel with extensive abilities to seek information and technical advice from persons or bodies to assist the panel in reviewing the matter under dispute. In particular, Appendix 4 sets out a mechanism for a panel to obtain the assistance of an expert review group in matters relating to scientific or technical issues. Article 14 provides that panel deliberations are to be confidential. Furthermore, confidential information that is provided during the course of a panel proceeding must not be revealed unless there is formal authorisation from the person or body submitting the information.

Article 15 creates a new procedure allowing the parties to a dispute to review a panel's findings and conclusions before the panel report is finalised. This is called the interim review stage, and it originates from the dispute settlement provisions of the Canada-United States Free Trade Agreement.

There are new provisions in the DSU concerning adoption of panel and Appellate Body reports. This represents a significant improvement over the existing GATT system. Article 16 provides that the DSB shall adopt a panel report within 60 days after it has been circulated to the members, unless a party to the dispute appeals the report to the Appellate Body or the DSB decides by consensus not to adopt the report.

Another important new feature of the DSU is the establishment of a standing Appellate Body under Article 17. The Appellate Body will hear appeals from panel reports. It will be composed of seven persons, who are recognised experts in law and international trade. Appellate review will be conducted within 60 to 90 days. Appellate Body reports are required to be adopted by the DSB and unconditionally accepted by the parties to the dispute, unless the DSB decides by consensus not to adopt the report. It will not be possible for a losing party to block adoption of a panel or an Appellate Body report.

Article 18 provides that there shall be no *ex parte* communications with a panel or the Appellate Body. Written submissions to a panel or the Appellate Body are to be treated as confidential, but the parties to a dispute may disclose their own positions to the public. However, members are required to treat confidential information submitted by another Member to a panel or the Appellate Body as confidential.

Article 19 provides that where a panel or the Appellate Body makes a finding that a measure is inconsistent with an agreement, it is required to recommend that the offending party bring the measure into conformity with that agreement. The panel or

Appellate Body may suggest other ways in which the member concerned can implement the recommendations. Panels and the Appellate Body, however, can only interpret, not modify rights and obligations provided in the WTO agreements.

The total time frame from the date of establishment of the panel until the date that a panel report is considered by the DSB for adoption, as a general rule, shall not exceed nine months, or twelve months where the report is appealed to the Appellate Body.

Article 21 contains significant new rules and procedures governing surveillance of implementation of panel or Appellate Body recommendations and rulings. It provides that an offending party must implement a panel or Appellate Body ruling within a reasonable period of time. The term 'reasonable period of time' is specifically defined.

The DSU provides greater clarity and precision with respect to what happens if a Member fails to implement the recommendations and rulings of the DSB within a reasonable period of time. It requires that where a government fails to implement a panel or Appellate Body ruling, that party must enter into negotiations upon request of the complaining party in order to reach agreement on mutually acceptable compensation. Article 22 provides that compensation is a temporary measure to encourage the defending party to implement the results of the panel or Appellate Body report.

Article 22 also provides specific rules concerning suspension of concessions or obligations, otherwise known as retaliation. There are specific time frames set out as well as specific rules concerning the principles and procedures that must be followed in seeking DSB authorisation to retaliate. Such rules include the general principle that the complaining party must first seek to suspend concessions or obligations in the same sector or in the same agreement as that in which the panel or the Appellate Body has found a violation. Also, there is a requirement that the level of suspension of concessions or other obligations must be equivalent to the level of nullification or impairment. Where there is a dispute concerning either the level of suspension proposed or a claim that the rules set out in Article 22 have not been followed, a new arbitration procedure is provided to determine whether the proposed retaliation is consistent with the rules. Where the arbitrator has made a decision concerning the level of retaliation or the means of retaliation, the DSB must be informed of the arbitrator's decision and may only authorise retaliation where it is consistent with the arbitrator's decision.

Article 22 is important for two reasons. It establishes clear rules and procedures concerning the implementation of panel reports as well as specific requirements concerning compensation and retaliation. In addition, it provides that the DSB shall authorise retaliation where the rules have been complied with. However, it also provides significant protection against unauthorised or excessive retaliation through the availability of a binding arbitration mechanism to resolve disputes concerning the proposed level or means of retaliation.

The DSU contains, in Article 23, an important, systemic defence against the use of unilateral measures. It requires that members must settle or resolve their disputes arising under the WTO agreements pursuant to the rules and procedures of the DSU. In other words, members are prohibited from making a unilateral determination that a violation has occurred or that a benefit has been nullified or impaired under any WTO agreement and from retaliating on a unilateral basis. This is a significant strengthening of the multilateral system, and provides members with rights and remedies in the event of an illegal unilateral act.

Special procedures are contained in Article 3:12 and Article 24 concerning disputes involving developing countries and least-developed countries.

Non-violation cases have their own special procedures set out in Article 26 of the DSU. These provisions, generally speaking, elucidate established GATT practice. In particular, these procedures make it clear that in a non-violation case, there is no obligation for the defending party to withdraw a measure in question. However, the defending government is required to make a mutually satisfactory adjustment in order to resolve the dispute, and compensation may be part of any final settlement.

Appendix 1 contains a list of the WTO agreements covered by the rules and procedures of the DSU. They include the WTO Agreement itself, the GATT 1994 and the 12 other multilateral agreements on trade in goods, the General Agreement on Trade in Services, the Agreement on Trade-Related Aspects of Intellectual Property Rights and the DSU. In addition, the PTAs, i.e., the Agreement on Trade in Civil Aircraft, the Agreement on Government Procurement, the International Dairy Agreement and the International Bovine Meat Agreement, will be covered by the DSU where the parties to those agreements agree. Appendix 2 sets out a list of the covered agreements containing special or additional rules and procedures concerning dispute settlement. Where there are special or additional dispute settlement rules and procedures in another WTO agreement, those provisions will prevail over any conflicting provisions of the DSU.

Source: WTO