Comment on chapter 20

A general equilibrium interpretation of some WTO dispute settlement cases: four EU–US trade conflicts

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Simon Schropp, in a structured law and economics approach, gives an excellent and critical survey of the major deficiencies of WTO arbitration. He discusses the different concepts of calculating the appropriate counterfactual in order to quantify the level of nullification and impairment. This leads him to conclude that it is nearly impossible to 'determine whether the level of suspension of concessions or other obligations (SCOO) is equivalent to the level of nullification or impairment (NoI)'. He shows in a nice little matrix that different scales (blocked trade or lost turnover; efficiency losses or lost profits; overall economic losses) and scopes (direct or sectoral impact and/or indirect or economy wide effects) lead to different outcomes when measuring the NoI. In my analysis I assume that the goal of the WTO treaty is not only to increase trade flows (reciprocal exchanges of market access) but to enhance – at least in the long run – overall welfare. In addition, I am concerned about the spill-overs or side effects of NoIs and also of any retaliation.

In order to underline my 'welfare cum general equilibrium effects' position I will refer to the results of calculations of the overall implications of some selected US–EU trade disputes. For this purpose I deal with a number of issues. First, is 'Rebalancing' retaliation in WTO dispute settlement more a myth than reality? Second, I provide examples of unintended side-effects in some transatlantic trade disputes – demonstrated in the case of the most prominent 'mini-trade' wars between the EU and the United States. Third, I offer suggestions for improvements of the dispute settlement system from an economic perspective.

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1 Is 'rebalancing' retaliation in WTO dispute settlement more a myth than reality?

The ability of the WTO to authorize trade retaliation as a response to persistent violations is perhaps the most salient, but also the most controversial feature of its dispute settlement system. Although the main purpose of retaliation is to achieve compliance, most authors seem to take it for granted that, by allowing the complaining member to suspend concessions and obligations under the WTO Agreements vis-à-vis the responding member at a level equivalent to the level of nullification and impairment caused by the latter's WTO-inconsistent measure (Dispute Settlement Understanding(DSU), Article 22.4), the current system of trade retaliation performs some kind of 'rebalancing'. My main thesis is that rebalancing is more a myth than reality.

Due to several side-effects, 'rebalancing' never means and never can be a restoration of the *status quo ante*. One reason is that even an identically specified measure will have different effects depending on the size and composition of the trade flow (sectoral implications). The other reason is that suspension must be targeted against the responding member, while the underlying violation will usually have covered trade with all members (third-country effects). But also the retaliation of one complainant against one violating member (for example, in many EU–US trade disputes) has external effects on other WTO members.

In practice, it is very difficult to 'calculate' the 'exact' damage or level of nullification or impairment. One simple approach, often applied by the WTO arbitrators is to approximate it by trade effects in the sense of lost trade (that is, lost turnover) as the relevant comparator. In *EC–Hormones* the calculation of the lost trade was by far the most transparent calculation. In *EC–Bananas* and in the other cases of EU–US trade disputes where sanctions were allowed, these calculations – according to Breuss (2004) – were neither transparent nor plausible. Whereas 'WTO retaliation authorizations are, in reality, arbitrary' (Spamann, 2006, 34), it seems that the outcome of the level of nullification is sometimes more the result of a political bazaar deal (Breuss, 2004, 2007).

Anderson (2002) shows theoretically that equal trade effects will only coincidentally, if ever, proxy for equal welfare effects. I have demonstrated elsewhere (Breuss, 2004, 2007) that the simply calculated foregone trade effects must, not however, coincide with the more proper welfare effects. Welfare effects are the standard comparator in economic policy analysis, and welfare improvements – and not only a simple increase in trade – are,

or should be, also the ultimate goal of the WTO Agreements. Although welfare effects are the only truly general comparator for the level of nullification, they are, admittedly difficult to calculate. A shortcoming of all the WTO arbitrators' calculations of the level of damage (or level of nullification) is that primarily partial analytical calculations are applied. However, without a general equilibrium analysis it cannot be done properly. Kohler (2004) in commenting on my general equilibrium calculations of the economic impact of the four transatlantic trade disputes interprets the concept of 'rebalancing' by weighing 'economic values' against 'political values'. For him, this makes it more understandable that although, as I have shown both, the plaintiff and the defendant may lose in welfare terms, both governments – due to political economy motives – still prefer the outcome to the initial situation (the original agreement). In Kohler's interpretation 'the DSM is a useful vehicle to "re-balance" the agreement, towards a new political equilibrium'.

2 Examples of unintended side-effects in some transatlantic trade disputes

Here I demonstrate examples of side-effects from the most prominent 'mini-trade' wars between the EU und the United States.[1] In order to overcome the usual shortcomings of the partial analytical calculations of the WTO arbitrators in the analysis of the economic impact of the four most prominent EU–US trade conflicts I applied a computable general equilibrium (CGE) model (GTAP5) using twelve countries/regions and seven commodities/sectors (Breuss, 2004, 2007). Here I refer to the major findings of this exercise only.

With this CGE setting the four most prominent EU–US trade conflicts: that is, *EC–Hormones*, *EC–Bananas*, *US–FSC*, *and US–Steel Safeguards*–were analysed. When either the US or the EU is retaliating against one another because of having violated WTO agreements we have the situation of a (retaliatory) 'trade war': both parties reduce trade by imposing trade-contracting measures simultaneously. As these trade disputes have a fairly low dimension – they amount only to between 0.01 per cent and around 2 per cent of bilateral EU–US trade in each case – I call them 'mini-trade wars'.[2] In the so-defined 'mini-trade wars' in three out

[1] Unfortunately, I cannot offer an equivalent quantitative analysis of the *US–Byrd Amendment* and the *US–Internet Gambling* cases.

of four cases both parties have or would have suffered a (slight) welfare deterioration. Only in *US–FSC* could the EU improve its welfare slightly.

2.1 Major findings

2.1.1 The level of damage

The four analysed cases showed that the estimation of the correct level of suspension of concessions 'equal to the nullification or impairment' is practically impossible. The calculation always involves the comparison between the actual situations with one hypothetical in which the trade measures would be WTO-legal. As such calculations always have to be made under uncertainty one should at least do this exercise under two conditions: (1) The arbitrators should make sensitivity analyses when fixing the level of impairment; and (2) they should allow for much more transparency. The concept of equivalence draws more on notions of fairness than on economic accuracy.

Hence, a complete 'rebalancing' is an illusion. If allowed to introduce retaliatory import tariffs in the amount of the 'damage', this will enhance reactions by importers and will reduce imports of the targeted products either completely (100 per cent extra tariffs act prohibitive) or not fully. In short, the damage calculated by WTO arbitrators may be quite different from the overall economic impact of the introduction of retaliatory measures in the economies of the complainant, respondent and also in third countries.

There are other flaws in the WTO dispute settlement system. It looks at future actions only. Past wrongs go uncompensated. Trade retaliation under the WTO targets non-compliance only after a 'reasonable period of time' has elapsed following a panel or Appellate Body finding against a respondent's illegal policy regime. The damage caused to the complainant's export industry in preceding years is simply ignored by DSU procedures. Furthermore, by retaliating it is the complainant's import-competing industries that enjoy temporary assistance because of the prohibitive retaliatory tariffs imposed. This does not help the export industry that has been denied market access by the respondent's wrong policy in the first place.

[2] A more detailed description of the history of these cases can be found in Breuss (2004, 2007)

2.1.2 Questionable system of retaliation

The WTO dispute settlement system's objective is twofold: (1) to obtain a satisfactory solution to the dispute in the interest of the disputing parties; and (2) more broadly to guarantee compliance in the interest of all WTO members. The present tariff sanction system is questionable for several reasons:

- it is counterproductive because it leads to trade contraction and hence goes against the very trade liberalizing principles of the GATT/WTO;
- retaliation does not bring relief to the exporters injured by the WTO-illegal measures;
- trade retaliation also damages innocent bystanders (external side-effects);
- existing remedies are unwieldy: the more trade of a country is affected by WTO-illegal measures, the more difficult it is to find imports that can be restricted without hurting consumers.

Additionally, theory and the empirical evidence (via simulations with CGE trade models) suggest that import tariffs may lead to a trade war. Trade wars can only be won by large (and hence, powerful) countries. This is the result of optimum tariff theory. That means that small (and more so, poor) less developed countries (LDCs) are discriminated against in two respects. On the one hand, due to a lack of legal resources they make less use of the WTO dispute settlement system, and on the other hand, if they are authorized to retaliate against a large country or trading bloc (like the EU), they do not implement such sanctions (for example, Ecuador in its 'cross-retaliation' case against the EU) either because they fear losing the trade war or necessary aid from the donor country (for example, from the EU) or they hope for preferential treatment in debt negotiations in the Paris Club. Countermeasures in the form of retaliatory tariffs are bad policy and amount to 'shooting oneself in the foot'. Through countermeasures, a small and poor WTO member imposes an additional cost on its own society. Precisely because of the budgetary constraints, adoption of countermeasures is simply not an option for the poorer WTO members. The present system of compensation in the WTO illustrates the disadvantageous position of LDCs. Even "cross-retaliation" in the area of TRIPS, which may have seemed promising from the perspective of compliance-seeking developing countries, does not offer them the relief they hoped for, as can be seen in Ecuador's experience in *EC–Bananas*.

2.1.3 Unpleasant implications of tariff retaliation

Retaliatory measures via import tariffs have a whole series of incalculable and unpleasant impacts. *EC–Hormones*, *EC–Bananas,* and *US–FSC* have demonstrated that retaliatory measures tend to injure a motley assembly of exporters and importers that are often smaller companies that rarely, if ever, have an interest in the original dispute (for example, bananas against luxury bags from 'Gucci').

In addition to these anecdotes, one can strictly prove from general equilibrium analysis of trade policy measures that the imposed tariffs on a randomly selected list of products (sometimes aggravated by a 'carousel' method) can have implications which were not foreseen by WTO arbitrators if they did not have access to a very detailed CGE world trade model. As long as such modelling devices are not at hand, the WTO Dispute Settlement Body's (DSB) decisions on retaliatory tariffs – although not carrying them out on their own but on behalf of the WTO member states – are irresponsible. The first promising attempts to correct such omissions can be found in the decisions of the arbitrators in *US–FSC* and *US–Byrd Amendment*.

2.1.4 Who controls the retaliators?

Furthermore, besides the problem of calculating the level of damage a country suffers as a result of another member not complying with WTO rules, the dispute settlement architects also overlooked the question of who controls the retaliators? Once the amount of impairment is set by the arbitrators in the WTO dispute settlement procedure, who controls whether the country which has been permitted to retaliate really only reduced imports by the amount authorized by the WTO? Additionally, who controls the distribution of the retaliatory tariff revenues? Are any of the collected revenues redistributed to the companies suffering the damage? In practice companies suffering the damage by WTO-illegal measures are not compensated out of the tariff revenues collected by the complainant government.

3 Suggestions for improvements of the dispute settlement system from an economic perspective

There are numerous proposals for improving and clarifying the DSU which refer to institutional and/or procedural changes. Nevertheless, rarely do they touch intrinsic economic problems with the dispute settlement system.

3.1 Transfers instead of tariffs for retaliation

A wide range of proposals for improving the WTO's system of remedies has already been put forward: my findings confirm that tariffs are very poor instruments for countermeasures. According to international law in case of compliance a basic principle is the right to request financial reparation for a wrongful act, including damages incurred in the past. The crucial remaining question is with which instruments should one execute the sanctions?

A much more efficient and easier retaliation instrument than tariffs would be direct transfers from the government of the non-complying country to the government of the country having got the authorization of compensation by the WTO. The latter government could than easily redistribute the received transfers to the companies which suffered the concrete loss. Such form of retaliation is often called 'financial compensation'. This is not a novel idea: reparation by governments of injury for which they can be held responsible is part of the tradition of public international law. It had already been proposed in the GATT in 1966 (see Bronckers and van den Broek, 2005, 110) and was also proposed more recently in the WTO. Such a transfer or financial compensation scheme has several advantages over the present tariff-ridden retaliation system. It solves more or less all the problems inherent in the retaliation system by tariffs. This method of retaliation would come closer to the ideal of "rebalancing" because there would be no negative external and distorting effects as with a tariff. Whether transfers as retaliatory measures would also be covered by the present DSU legislation is an open question. Article 22.1 of the DSU does not refer to tariffs explicitly only to 'compensation and the suspension of concessions or other obligations'.

Suspension of concessions as a rule implies the reintroduction of tariffs since the major part of concessions in former GATT rounds consisted of tariff reductions. One could (newly!) interpret 'other obligations' as the duty of countries not complying with WTO rules to pay transfers to the countries hurt by the non-compliant action. This should be a recoverable claim, determined by the usual DSU procedure. The problem, however, is that the complainant would interfere in the respondent's national sovereignty – something excluded from the present WTO system. In any case, this would require amendment of the DSU (see also Bronckers and van den Broek, 2005, 123ff).

3.2 Compensation instead of retaliation

There are other suggestions put forward to improve the retaliatory procedure. Anderson (2002) pleads for compensation instead of retaliation. A complainant unhappy with the respondent's policy reform should be entitled to seek compensation until satisfactory reforms are implemented. Compensation could come in the form of temporarily lowering the respondent's import barriers on some other products on a most-favoured-nation (MFN) basis. Instead of the restrictive effect of retaliation to both countries involved in the trade dispute, compensation in this form would simply mean trade liberalization. According to Anderson (2002), the concept of compensation would not only favour the complainant but also third countries, and by granting compensation the respondent would gain greater control of procedures. With retaliation, by contrast, the complainant can keep pressure on the respondent until the latter complies. Anderson's suggestion, however, would confuse the ongoing general liberalization rounds under WTO. What Bronckers and van den Broek (2005, 107) have called a 'mandatory compensation' system also has its disadvantages.

The advantage of trade compensation, as opposed to retaliation, is that compensation does not restrict trade but actually opens it up, albeit temporarily, for as long as the non-complying measure remains in place. In practice, however, compensation is hardly ever offered because it is very difficult for countries to find and offer compensatory reductions of trade barriers.

3.3 Tradable retaliation rights

Mexico has proposed that retaliation rights be made tradable (Bagwell, Mavroidis and Staiger, 2006). Its proposal came out of recognition of the problem that small and developing countries have difficulty in finding the capacity to retaliate effectively against trading partners. Bagwell, Mavroidis and Staiger (2007) offer a first formal analysis of the possibility that retaliation rights within the WTO system be allocated through auctions and present results, that are however, highly sensitive to the auction format chosen.

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