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WTO Dispute Settlement: Four EU–US Mini Trade Wars—A Rejoinder

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1. Introduction

It is interesting and comforting that the four commentators agree with the major parts of my arguments put forward in my critical analysis of the four most prominent EU–US trade conflicts. First of all this concerns the undesirability of tariff retaliations as a trade policy. Second, there is agreement that the WTO DS system has a ''large country bias.'' The agreement is already less unanimous when it comes to the demand for more transparency in the decisions of the arbitrators and to the use of more accurate economic calculus with CGE models in the WTO. Ichiro Araki and Alexander Keck call into question my proposal to substitute retaliation by tariffs with direct transfers. Araki and Wilhelm Kohler question my notion of ''mini trade wars'' when dealing with the most important EU–US trade conflicts, although later, Kohler agrees with this labelling. Nobody disagrees with the view that the WTO system in general and the DS system in particular is a very complex nexus of economic, political and legal forces, oscillating—in the words of Wilhelm Kohler—between ''battlefield and cooperation.''

The commentators approach the problems with the present WTO DS system from different angles and enrich their analysis with specific features: Ichiro Araki deals with the involvement of Japan in the DS process and concludes that Japan was less aggressively using the retaliation option than other big players like the USA or the EU. Tim Josling stresses the necessity of considering not only the economic side of the coin but also the individual political history of each conflict in order to really understand the whole economic–political nexus of trade disputes before the WTO. Wilhelm Kohler's aim is not to deal with the cases analysed in my contribution in detail but explores the general logic of the WTO–DS system and interprets my results within the context of a Bagwell–Staiger type economic model of the GATT/WTO. He finds that non-compliance is a form of non-cooperation or the breach of former cooperation in the trade negotiations. In my opinion, the three country model by Maggi (1999) might even be more realistic to analyse the mechanism of the WTO DS system, as it allows to

study the asymmetry of power (one large versus two small countries) much better than the symmetric case of two large countries trading two goods in the Bagwell–Staiger type model. Alexander Keck underlines my observation that the role of economics in WTO dispute settlement and its analysis was and is modest. Until recently, lawyers have dominated this area.

2. The purpose of retaliation and the logic of the WTO

Retaliation is only understandable within the context of the logic of GATT/WTO. From an economic point of view for Maggi (1999), Bagwell and Staiger (2002) and Wilhelm Kohler the twin principles of reciprocity and non-discrimination are the basis of the GATT/WTO world trade system. When used together these simple rules can deliver an efficient outcome. Non-discrimination (the MFN clause) ensures that all international externalities are channelled through world-price movements, and the principle of reciprocity serves effectively to neutralize externalities of exactly this nature (terms-of-trade effects). As the WTO has no direct enforcement power, it delegates the task of rebalancing the system in case of a breach of WTO rules to its member states via the authorization to retaliate, mainly by tariffs.

Ichiro Araki stresses more the legal point of view. In his comment he reminds us of the old debate (mostly carried out between lawyers) about the purpose of retaliation. There are two extreme schools of thought: one is based on ''voluntary compliance'' and stressing the contractual nature of the GATT/WTO system, another doctrine sees the purpose of the new DS system in ''induced compliance.'' Araki therefore calls for a new model to explain the actual working of the WTO along the line of judicial supervision (a hybrid of contractual and judicial models).

Ichiro Araki asks which position is implied in my analysis. Well, I take up a very practical position. The WTO has no direct power to enforce compliance. With the DSU, however, it generated an arbitrating body which is accepted by all member states. When the arbitrators have decided over a case they may authorize the defending party to retaliate. It is then a question of bilateral relations (in our case of the four trade conflicts—between the EU and the US). Then a change takes place. Former multilateral agreements are delegated back to bilateral relations. Whether the country which is confronted with retaliation gives in is just a question of economic and political power or goodwill (balancing the ''reputational costs''). The WTO itself has no means to enforce a resolution. Therefore some, like Bronckers, call for ''more power to the WTO,'' a demand which in the end should result in a ''world government!''

What I have criticised—and which was accepted by all commentators—is that retaliation with tariffs can have extreme peculiar results. Retaliation with tariffs can be done in any sector—not only in the sector where the breach of WTO rules has occurred. In the Bananas case the US retaliated not in the sector agriculture or bananas but in far off sectors like Guchi bags! This kind of retaliation has external effects not only for the economy imposing retaliatory tariffs but also for third countries! Such external and third country effects cannot be captured by two-country models like those of Bagwell–Staiger

or Kohler, may be with a three-country model à la Maggi, but in any case with a full-fledged multi-sectors, multi-countries CGE model.

3. Do we really need more transparency?

Kohler agrees with me that an exact calculation of nullification and impairment is practically impossible. A correct estimate is only be reached by incidence. But do we really need an exact calculation? Kohler's answer is yes, if fairness is expected from the DS system and if the WTO will target a ''welfare goal.'' Welfare calculus—like those suggested in my analysis—is then necessary and appropriate for the future course of the WTO. Araki, however, takes a different position. He does not see the need for more transparency and therefore for more exact economic calculus. He justifies his position by an interesting hint. He points to the ironical fact that reciprocal trade concessions made in the GATT/WTO rounds never imply ''exact calculations.'' Rather, a rough figure of trade volume is usually used to calculate the expected benefits of trade liberalization. This might be a good and practical argument against an exact calculation, economic theorists, however, would not be satisfied with such an argument.

Tim Josling criticizes that economic models lack a memory of the history of the disputes. According to him, changes in the ''political balance'' should be included in the economic calculus; if not calculations such as mine are ''anything more than accounting exercises of little interest outside the profession.'' Well I can agree with such a verdict. But it is very complicated already to build a comprehensive and detailed (many goods and countries encompassing) CGE model. Additionally to include all possible political behaviour patterns would overload any model.

Although Alexander Keck has much sympathy for a more prominent role of economic analysis in dispute settlement, he nevertheless mentions the fact that often economic analysis is not required to deliver a decision. In order to strengthen the role of economics in dispute settlement, he advocates a complete overview of WTO cases based on whether or not economic analysis was an integral part of the adjudication process—a work which is underway at the WTO.

4. The political nature of trade conflicts

I agree with Tim Josling that a full understanding of the EU–US trade disputes needs the consideration of their particular history and political implication. That is exactly what I have done in my analysis. Frontloaded to my model calculations I have told each story of the four trade conflicts. Hence, for a theoretical understanding of trade conflicts like those I have analysed the Grossman and Helpman (1995) politico-economic model might be a better instrument than the simple Bagwell–Staiger or Kohler model.[1] In the latter the political dimension is absent whereas Grossman and Helpman modelled endogenously

1 In order to better understand the EU–US Bananas case with all its political and economic implications I have applied the Grossman–Helpman model. (see Breuss, 2003, p. 146–151).

the lobbying nature of tariffs and retaliation. The steel case was a prototype of such a situation. A lobby group in the steel belt around Pittsburgh forced President Bush to introduce temporary safeguard measures. The political counter pressure by the European Commission was also subtle. It concentrated its threat for retaliation on specific products from Florida, which is one of the most important states for re-election for President Bush. Bush gave in! According to trade officials in the future the European Commission will more and more play the politico-economic card when it comes to enforce compliance in a particular trade dispute—in particular against the USA.

5. Enforcement problem

As stated earlier, the WTO has no direct enforcement power. It can only give the power to members to put pressures on other members via introducing retaliatory measures. Or to say it in the words of Bello-Hippler (1996), quoted in Ichiro Araki's comment, ''the WTO has no jailhouse, no bail bondsman, no blue helmets, no truncheons or tear gas. Rather, the WTO—essentially a confederation of sovereign national governments—relies upon voluntary compliance.'' Maggi (1999) in a three country model works out the major advantages and disadvantages of the actual WTO DS system as far as enforcement is concerned and derives the following propositions. (i) In the presence of bilateral imbalance of power (small and large countries are involved in world trade), countries can sustain a higher symmetric equilibrium payoff (welfare) with multilateral enforcement (this is a mechanism with a punishment strategy whereby any defection—non-compliance with WTO rules—is followed by permanent Nash reversion in both bilateral relationships which the defector is involved in) than with bilateral enforcement (this is a mechanisms with a punishment strategy whereby a defection (breach of WTO rules) by one country against another is followed by a permanent reversion of (only) these two countries to the static Nash tariffs). (ii) Under bilateral enforcement, the weaker partner (the smaller country) makes a larger ''concession'' than the stronger partner (the large country). The reverse is true under multilateral enforcement. (iii) Absent power imbalances (if all countries would be of equal size), bilateral and multilateral enforcement are equally efficient.

Kohler interprets non-compliance as a cooperative game in the Bagwell–Staiger model context. This is a symmetric tariff-prone model with two large countries with two goods. A repeated game paradigm rests on self-enforcement, meaning that two countries try to find an agreement. But ''self-enforcement'' is not played symmetrically between the WTO members (''large country bias''). Kohler states that in practise unilateral violation of any one agreement does not mean a ''collapse'' of that agreement. The reason is of course that in reality 147 WTO members agreed multilaterally on all agreements. So if only one pair of countries breaches the agreement, the agreement itself is still intact.

6. How to enrich the instrument box of the DS system?

How to overcome the ''large country bias'' of the DS system? Large countries have a bigger option to retaliate in a whole variety of products whereas less developed

countries, urgently depending on industrial product imports have practically no option to retaliate without huge ''shooting in the foot'' effects. Additionally, large countries have the whole power of lawyer capacities at the WTO whereas LDCs have to rely on assistance by the WTO secretariat. And last but not least large countries are predominantly winners of trade wars. This asymmetry is not covered in simple models like those of Bagwell and Staiger or Kohler. However, three country models like those of Maggi capture such features. All in all—most of the commentators agreed upon that—tariffs are very bad instruments for retaliation. My suggestion—a direct transfer system—would avoid the ''large country'' bias and the unnecessary (unpleasant) third country effects. Each country, large or small, rich or poor would have the same chance to use an instrument which could force compliance and would not have the negative side effects of tariffs. Only Araki and Keck have doubts as to the practicability of my suggestion of a transfer system instead of retaliatory tariffs. Also the proposal of compensation instead of tariff retaliation by Anderson (2002) was not discussed by the commentators. Only Kohler mentioned this possibility but excluded it from his further theoretical analysis.

The proposal by Mexico (WTO, 2002) for improvements and clarifications of the DSU is on the one hand one of the most innovative one but on the other hand also one of the least realistic one in terms of legal feasibility. First, it rests on a very important observation, namely that one of the fundamental problem in the WTO DS system lies in the period of time during which a WTO-inconsistent measure can be in place without the slightest consequence. Illegal measures may be in place for more than three years before a complaining party can obtain compensation or suspend concessions or other obligations. According to the Mexican point of view this situation amounts to a ''de facto waiver'' in which a Member can maintain a WTO-inconsistent measure which unduly harms exporters. Mexico therefore proposed a procedure to step up the determination and application of nullification and impairment by using ''preventive measures.'' In legal terms this means the application of ''retroactivity'' comes into play. The right to take provisional measures would imply a quick authorization for retaliatory measures. ''If the final level of nullification or impairment turns out to be lower than that of the preventive measures authorized, the party complained against should be entitled to compensation for such excessive application of preventive measures, which would restore the original balance of rights and concessions'' (WTO, 2002, p. 5). The second important observation concerns the fact that many ''WTO members may not be able to find a trade sector or agreement in respect of which the suspension of concessions would bring about compliance without affecting its own interest'' (WTO, 2002, p. 5). In other words many developing countries and least-developed countries have not the power to retaliate. Therefore Mexico makes an innovative—although not very practicable-proposal. Members should be allowed to ''negotiate'' the right to suspend concessions or other obligations towards another Member. ''Negotiable rights'' should be ''tradeable.'' The problem is the ''price'' of such a deal. Here, Mexico says that country ''A'' may agree with ''B'' the transfer of the right to suspend concessions or obligations to ''C'' in exchange of a mutually agreed benefit, which may even take the form of cash (WTO, 2002, p. 5).

Bagwell et al. (2003, 2004) were the first to theoretically explore the conditions and implications of such a ''property-rights'' approach. Kohler and Araki make several reservations as to the practicability of the Mexican approach.

7. Conclusions

In the sense as Churchill put it, ''democracy was the worst system of governance except all those other systems which have been tried from time to time,'' one could qualify the WTO DS system as the best available multilateral system arbitrating trade disputes. However, each system can always be improved. Several propositions are already at the table of the Doha round negotiations—from the member states delegations and from the academia. In the ''Doha Work Programme'' adopted by the General Council on 1 August 2004 in order to re-launch the Doha development round ''Dispute Settlement'' rank prominently under point f. ''Other negotiating bodies.'' The Doha mandate calls for progress in this area of the negotiations. Starting from the above analysis of the four most prominent EU–US trade disputes the commentators—arguing primarily economically, but also politically and legally—pointed to many areas where the DS system can be improved. In paraphrasing the concluding words of Ichiro Araki the engagement in serious academic discourse over the improvement of the WTO dispute settlement system is urgently needed, not only by trade politicians and lawyers but also by economists.

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