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The Law, Economics and Politics of Retaliation in WTO Dispute Settlement

Edited by
Chad P. Bown and Joost Pauwelyn

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CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVERSITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore,
São Paulo, Delhi, Dubai, Tokyo

Cambridge University Press
The Edinburgh Building, Cambridge CB2 8RU, UK

Published in the United States of America by Cambridge University Press, New York

www.cambridge.org
Information on this title: www.cambridge.org/9780521119979

First published in print format 2010

ISBN-13 978-0-511-66916-3 eBook (Adobe Reader)

ISBN-13 978-0-521-11997-9 Hardback

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Introduction

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

CHAD P. BOWN AND JOOST PAUWELYN*

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

* The editors of this volume would like to offer a special thanks to Miguel Burnier, Ph.D. candidate at the Graduate Institute in Geneva, for his excellent help in editing the many contributions to this book.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

exports'): think of countries like Japan, Korea, China and Taiwan. In contrast, trade sanctions will present less of a threat against countries that have few exports, or export mainly homogeneous or fungible goods, such as oil or other raw materials which can be easily diverted or sold to other countries: think of countries like Nigeria, Venezuela or Saudi Arabia. On that basis, Evenett concludes that there exists a 'clear WTO enforcement club' of nations whose bilateral trade flows are sufficiently large that they have some clout over several importing nations.

Interestingly, and here is where Evenett meets Nottage, according to Evenett, this 'WTO enforcement club' increasingly includes developing countries, especially in East Asia. One of Evenett's conclusions is, therefore, that East Asian countries should step up their role in WTO enforcement and play a more active part in WTO dispute settlement.

One way to possibly make trade retaliation more effective for smaller developing countries is to learn from the experience of developed WTO members. The contributions in this volume on the United States, EC, Canadian and Mexican experience all refer to various techniques to impose what one could call 'smart sanctions'. The general guidelines for such 'smart sanctions' should be to (i) *minimize* the harm caused to the sanctioning country, while at the same time (ii) *maximize* the impact of the sanctions in the violating country.

A crucial way to *minimize harm at home* is to conduct internal consultations with stakeholders (especially importers) before actually imposing sanctions. In this way, products sourced from the violating country which cannot be easily replaced by imports from other countries can be identified and avoided. Khabayan refers to Brazilian orange juice that is not easily substituted in the same quantities for importation into Canada. Nordström talks of the vehement objections raised by the importer and dealer of Harley-Davidson motorbikes in the EC when motorbikes were put on a potential retaliation list against the United States. In the EC a notice for comments on a proposed retaliation list against the United States in *US–FSC*, explained that the list had on purpose been limited to 'products for which the average US import share (in value) in the period 1999–2001 represents a maximum of 20% of the average total imports into the EU'.[1] Malacrida goes as far as proposing that explicit rules should be included in the DSU to oblige retaliating countries to set up a domestic

[1] 'Notice relating to the WTO Dispute Settlement proceeding concerning the United States tax treatment of Foreign Sales Corporations (FSC) – Invitation for comments on the list of products that could be subject to countermeasures' (2002/C 217/02), *Official Journal of the European Communities*, 13 September 2002.

notice-and-comment procedure before finalizing retaliation lists. Salles, in turn, criticizes the implementation system currently in place in Brazil for not providing such public consultations. Yet, as Ehring illustrates, even with such consultations, surprises may still occur, as in the upset caused to American football clubs based in the EC when the EC blocked US imports under a relatively broad tariff line which turned out to include cheerleader pom-poms that could be sourced only from the United States!

Nordström is less enthusiastic about internal consultations as a tool with which to strengthen WTO retaliation. In his experience, EC member states and industries do all they can to 'keep the sanctions out of their own backyard … What was supposed to be a carefully laid out strategy became a free-for-all party … Everyone agrees with the objective, but no one wants to pay the bill.' To avoid what he calls the 'substitution mess' Nordström makes two (alternative) suggestions. First, innocent victims within the retaliating countries should be compensated by the government ('It is not unreasonable, in my opinion, to compensate individual firms that carry a disproportionate burden of a trade dispute on behalf of the Community. The common burdens should be carried equitably and not distributed at will.'). Second, Nordström proposes what he calls a 'long list' approach which would replace the currently prevailing method of imposing 100 per cent duties on a 'short list' of products with the alternative of imposing a very small additional percentage (he refers to 1 per cent in *US–FSC*) on *all imports* coming from the violating country. This would do away with internal consultations (since all products would be automatically on the 'long list'), equitably share the burden of retaliation (thereby avoiding any government compensations) and even have a positive (tariff) revenue side (in *US–FSC*, with a 1 per cent additional tariff on all US imports amounting to approximately $US2 billion a year). In response to the objection that this may take away the 'bite' of the retaliation as it is felt in the violating country, Nordström argues that 'the power of trade sanctions is overrated … Economic coercion can certainly add some extra pressure to comply, but the decisive factor is often the legal ruling *per se* and the bad reputation it would earn a government that refuses to stand by its international obligations. Even a "small" punishment would signal the resolve of the Community and the additional tariffs, however small, will be an irritant for the export industry in the targeted country, and hence also a problem for the government concerned.'

Similarly, and although imposed on a 'short list' of imports (instead of all imports as proposed by Nordström), Ehring explains that the EC retaliation in *US–FSC* was not in the form of the traditional 100 per cent

duty but in the 'cleverer' form of 'a 5 per cent additional import duty, to be increased by 1 per cent every month for a period of one year, until the level of 17 per cent'. Along similar lines, Huerta Goldman explains how Mexico in *US–Byrd Amendment* imposed varying duties depending on the product (9 per cent for chewing gums, 30 per cent for certain dairy products and 20 per cent for certain wines, champagnes and other sparkling wines). Illustrating yet another method to minimize harm in the sanctioning country (or even to create some benefits), the first guideline for 'smart sanctions' mentioned earlier, Huerta Goldman describes how Mexico in a NAFTA dispute (*US–Brooms*) focused its retaliation on 'defensive interests', namely US imports of high fructose corn syrup, so as to offer protection to Mexican cane sugar producers who were more than happy to substitute for any lost imports. Along the same lines, Andersen and Blanchet point out that 'pursuant to Section 407 of the Trade and Development Act of 2000, [US retaliation lists] must include, where possible, at least some reciprocal goods of the industries affected by the failure of the foreign country or countries to implement the recommendation'.

Turning now to the second guideline for 'smart sanctions', namely, *maximize the impact* of the sanctions *in the violating country*, the impact thus sought could be economic or political, or both. That the EC retaliated against Florida orange juice and other products from 'battle ground' or 'swing' states in US President Bush's 2004 re-election campaign is well known. The political pressure (or at least message) exerted by such targeted sanctions is clear. As Renouf puts it, 'skilful targeting of economic sectors in the losing party may ultimately have more impact than the total amount of countermeasures'. Ehring further explains how relatively low duties, rather than prohibitive tariffs, may actually exert more pressure on the violating country. As 'irritants' rather than 'bans' they may keep the pressure on for much longer: 'a frustrated exporter can have a more powerful voice domestically than an eliminated exporter that has gone out of business entirely or that has lost a certain export market without hope to re-conquer it quickly'. Put differently, it is not enough to take the 'hostage' that 'screams the loudest' (that is, to select a product whose producer has a lot of clout with the government of the violating county). In addition, retaliating countries should keep in mind that, in most cases, a 'screaming hostage' (trade irritants) is worth more than a 'dead hostage' (trade bans).

To further drive up the pressure, Andersen and Blanchet refer to the option in the United States of a so-called carousel (where products on the retaliation list are changed every 6 months). Yet, they note that, even in

the United States, such a carousel has so far not been activated. Interestingly, however, after the Workshop and just before sending this book to press, the United States did change its 1999 retaliation package in *EC–Hormones*, a move that is likely to trigger a WTO dispute over 'equivalence'. In what many saw as a 'parting shot' (against France) from outgoing President Bush on 14 January 2009, the United States not only changed the product list but also increased the retaliatory duty from 100 to 300 per cent on one single product, namely, Roquefort cheese.[2] The duty is thereby clearly meant to be punitive rather than compensatory (contrary to the 'screaming' versus 'dead' hostage analogy made above). Yet, the product chosen may be an exceptional case and a near perfect example of a 'screaming hostage'. It exemplifies the political targeting referred to earlier. Although US sales of Roquefort represent only 2 per cent of annual sales, as *Time* reported, '[y]ou can laugh at their accents, mock their leaders, and even ban their fries from the Congressional menu without getting much of a rise from the *French*. But start messing with their beloved cheeses, as the U.S. has now done, and *the famous Gallic shrug* will rapidly give way to outraged shouts of protest'.[3] Indeed, within a week, Roquefort producers, led by media star and former presidential candidate, José Bové (himself a Roquefort farmer), protested in the streets of Paris and hand-delivered 7 kg of Roquefort to the US Ambassador to France.[4]

Cross-retaliation is often referred to as another way for smaller developing countries to use WTO retaliation more effectively as a tool to induce compliance by larger WTO members. Whereas sanctions in the form of trade restrictions may harm one's own economy (especially where sanctions are imposed on inputs), not paying royalties to foreign patent holders or otherwise suspending intellectual property rights of nationals in the violating country may both increase welfare in the sanctioning economy (at least in the short term) and exert greater political pressure in the violating countries. Yet, the economic, legal and political complications raised by WTO retaliation under the TRIPS as well as GATS agreements are manifold, as discussed in Zdouc, Abbott and Appleton.

[2] 'Modified list of EU products subject to additional duties', 14 January 2009, available at: www.ustr.gov/assets/Document_Library/Federal_Register_Notices/2009/January/asset_upload_file64_15289.pdf.

[3] 'France fumes over US Roquefort Tax', *Time*, 16 January 2009, available at: www.time.com/time/world/article/0,8599,1872241,00.html.

[4] 'Roquefort: une délégation d'élus locaux reçue à l'ambassade des US sans Bové', L'Express, 21 January 2009, available at: www.lexpress.fr/actualites/1/roquefort-une-delegation-d-elus-locaux-recue-a-l-ambassade-des-us-sans-bove_734993.html.

Contributors (see, for example, Sebastian, Hunter and Zdouc) agree, however, that arbitrators have liberally interpreted the DSU's pre-conditions for countries to be authorized to cross-retaliate (thus far not a single developing country that so requested has been denied the right to cross-retaliate). Nonetheless, Sebastian expresses the view that 'even this deferential review arguably goes beyond what was envisaged by the negotiators of the DSU'. Along the same lines, Zdouc points to a DSU review proposal by Cuba, India and Malaysia whereby developing countries would be completely free to cross-retaliate against developed countries in any trade sector and under any covered agreement without having to state reasons. Zdouc argues that '[i]f the objective is to induce compliance by using the most effective form of retaliation or to punish the perpetrator for its non-compliance, then [this reform proposal] is the more promising alternative'. In any event, one point on which several authors in this volume agree is that IP conventions concluded under the auspices of WIPO should not stand in the way of WTO members implementing an authorization to suspend parallel IP obligations under the TRIPS Agreement (see Abbott, Ehring and Zdouc). Zdouc, Director of the WTO Appellate Body Secretariat, for example, makes the point that '[c]ross-retaliation under the TRIPS Agreement cannot effectively induce compliance unless structures are developed to avoid a situation where a WTO Member exercising its DSB-authorized right to suspend TRIPS obligations faces conflict with its obligations under other international or national regimes'.

Finally, that developing countries may, therefore, be able to design 'smart' and effective sanctions, or at least credibly threaten with such sanctions especially when viewed in combination with other, 'informal remedies', is underscored by the somewhat enigmatic statement by Mendel (counsel for Antigua) that, for Antigua in *US–Gambling* 'the ultimate application of the sanctions should not be ruled out. Even at the low level approved by the two arbitrators, the application of the authorised sanctions might prove to be effective. Antigua has a strategy for the application of its remedies which could very well have the intended effect.'

3 'Accurately calculating the authorized level of retaliation is a myth and close to impossible'

A third and final recurring theme in discussions on trade retaliation, including in this volume, is that whatever the goal, metric or benchmark selected, the calculation of authorized levels of WTO retaliation is, at present, not 'very scientific'. Cynics point out, for example, that in

many arbitrations the final amount awarded was suspiciously close to the average between what the complainant asked for and what the defendant suggested as the 'nullification or impairment'. The disarming, but nonetheless troubling, statement by the arbitrators in *US–Gambling* below was referred to several times during the Workshop as well as in this volume:

> we feel we are on shaky grounds solidly laid by the parties. The data is surrounded by a degree of uncertainty. For most variables, the data consists of proxies … and observations are too few to allow for a proper econometric analysis … we are left with preciously little information and guidance. Nevertheless, we will attempt to stay as closely to the approaches proposed by parties as possible and to make a maximum use of the limited information base we were given.[5]

Based on this and other observations, Schropp concludes that 'Arbitrators have failed to fulfill their mandate of safeguarding the equivalence standard … The calculation of the level of [nullification or impairment] was under-compensatory for the complaining parties, arbitrary in its choice of counterfactuals, and inept to address violations of non-market access WTO entitlements.' Ehring, in no hidden terms, refers to the *US–Gambling* arbitration as a 'judicial disaster'.

If the arbitrators' calculation of 'nullification or impairment' caused by the original violation is controversial, as many contributors to this volume have pointed out, this may only be the first part of a more complex three-step exercise. The instruction to arbitrators in DSU, Article 22.4 requires that (i) the level of 'suspension of concessions or other obligations' (SCOO) is (ii) 'equivalent' to (iii) the level of 'nullification or impairment' (NoI) caused by the violation. Arbitrators have, however, so far limited themselves to only the third element, that is, putting a dollar figure on NoI. With one exception (*EC–Hormones*), they have not checked or determined the level or impact of the SCOO proposed by the retaliating country (point (i) above), nor evaluated whether the two (that is, NoI and SCOO) are 'equivalent' (point (ii) above). Schropp, Sebastian and Davey in contributions to this volume all agree that arbitrators can, and should, examine not just one but all three of these steps. Following this track, Zdouc, Abbott and Appleton explain some of the complications in calculating the impact or effect of suspending obligations under the TRIPS or GATS agreements (including when calculating the level of SCOO in cross-retaliation cases).

[5] *US–Gambling*, Arbitration under Article 22.6, DSU, paras. 3.173–4.

Bown and Ruta, in their economic assessment of the ten arbitration reports so far, are more positive, concluding that '[i]n many of the DSU cases that we examine … the arbitrators' actual approach appears quite consistent with the Bagwell and Staiger reciprocity formulation theory'. Sebastian ends his legal assessment with a mixed message: 'arbitral panels have been broadly consistent in the basic approaches'; however, '[g]iven the open texture of the standards involved and the limited number of awards so far, there remains considerable room for refinement and development in this area of law'.

If the work of WTO arbitrators on retaliation is tested against the standard of accurately setting the precise amount of 'nullification or impairment' so as to fully compensate (yet not *over*compensate) the complainant or to carefully rebalance the scales, getting it 'exactly right' is crucial. Indeed, if the theory of 'efficient breach', referred to by Sykes, is to have any currency in the WTO, the system must be able to accurately 'value' WTO entitlements so as to avoid the cost related to error and, more importantly, not to *under*compensate (which would lead to 'too many' breaches) nor to *over*compensate (which would lead to 'not enough' breaches). Sykes concedes that his reference to 'expectation damages' and 'efficient breach' in private contract theory is only a 'crude analogy', first, because nothing in the DSU ensures or obliges the actual imposition of retaliation (thereby running the risk that the 'price of breach' is *too low*) and, second, because 'the question of how to measure and operationalize "equivalence" [in WTO retaliation] is much less clear than in the private contract setting'.

Indeed, most contributors to this volume seem to think that the current system is *under*-compensatory. Davey, for example, disagrees with Sykes 'that we need to worry about making breach more costly or too costly … the consequences of breach are often not very costly at all, compared to the damage done … because remedies are prospective and available only after a very long legal process is completed … breach is, if anything, cheap'. Schropp is of the same view: 'Opting for reliance damages as the baseline counterfactual and taking the end of the [reasonable period of time, instead of the time at the which the illegality arose] as starting-point of damage-calculation results in an under-compensatory benchmark … this prompts excessive breach on the part of injuring parties and inefficiently little *ex ante* trade liberalization by prospective complainants.' Pauwelyn concludes that 'the nature of WTO entitlements is such that putting an accurate value or price on WTO entitlements is difficult, costly and prone to either over- or (especially) undervaluation. The limited

practice of WTO suspension arbitrations … leaves no doubt that the calculation of "equivalent" suspension – that is, the pricing of WTO entitlements – is at best an approximation, at worst an educated guess; it clearly is an art, not a science.'

If, in contrast, the idea of calculating and authorizing WTO retaliation is to put an upper limit on sanctions that can be imposed so as to effectively induce compliance (without really punishing the violator), then getting it 'about right' may be more acceptable (the way countermeasures in public international law, think of an armed counteract, need only to be 'proportional' to the original breach). As Winters puts it with reference to former GATT Director-General Arthur Dunkel: '[r]eciprocity is difficult to pin down precisely … "[it] cannot be determined exactly, it can only be agreed upon"'. Along those lines, Malacrida's suggestion of optional or even mandatory 'final offer arbitration' is intriguing. Under such systems both parties would simultaneously submit their final best 'estimates' of the level of nullification or impairment to the arbitrator. The arbitrator would then have to select one of the two proposed levels. Since both parties know in advance that the arbitrator has to select the more appropriate estimate, each party has an incentive to submit an estimate that is reasonable.

Apparently supporting the idea that getting it 'about right' is as much as we can hope for, Sacerdoti puts WTO arbitrations on retaliation in the context of 'discretionary' determinations 'similar to an *aequo et bono* decision' and the distinction between legal and non-legal disputes (arguing that the absence of the possibility to appeal retaliation awards 'confirms that the subject matter was viewed as involving predominantly non legal issues'). Mendel goes a step further, arguing that the award in *US–Gambling* 'bears many of the features of an essentially political approach'. On the question of appealing retaliation awards, Ehring, in contrast, suggests that the legal issues in such awards should be made subject to review by the Appellate Body. Making the comparison to investor–state arbitration awards on compensation, Kaufmann-Kohler defends the idea of giving broad discretion to the arbitrators. In her view, this allows them 'to take into consideration the nature of the investment and all the surrounding circumstances, which can vary significantly' as well as possibly 'to factor into their end result some considerations of fairness'.

That said, mere complexity of the facts and economics involved should not lead arbitrators to throw up their hands and simply make an educated guess. The contribution by Bown and Ruta underlines the fact that economic formulas are available to 'get it right'. In addition, two recurring

suggestions to facilitate the process are made in this volume. First, arbitrators should increase the input of economics and economists in their calculation process. Bown, and Malacrida in his comment to Bown, agree on that point. A debate remains on whether economists themselves should be on the arbitration panel and what the precise involvement of economists on the WTO Secretariat support staff should be. Malacrida is less enthusiastic than Bown in this respect. He calls for 'a healthy degree of caution … in view of the limitations of quantitative economics' and stresses that input by economists must be limited to 'non-binding guidance'. Most contributors agree, however, that arbitrators can and should appoint independent economic experts to assist them. Sacerdoti, a current member of the WTO Appellate Body, describes the situation as follows:

> It is clear that competence in trade, economy, statistics, consumer behaviour, price elasticity and products substitution are called for. Although the DSU is silent in this respect, recourse to experts by the arbitrators, as panels are authorized to do under Art. 13 DSU, should be possible. Such a possibility should be welcome, because it might supplement the material that the litigants themselves may supply in disputes generally.

Kaufmann-Kohler draws on her experience as a long-standing arbitrator in investor–state disputes to come to the same conclusion. She refers to the difficulty for arbitrators to assess 'the accuracy of conflicting expert valuations produced by the parties' and suggests, as possible solutions, 'the appointment by the tribunal of its own damage expert to assist it in evaluating the evidence of the party-appointed experts' as well as the 'need for more involvement of economists in investment arbitration'.

A second recurring suggestion to improve the accuracy of WTO retaliation calculations is for arbitrators to find ways to collect more data and evidence from the parties or elsewhere (see Bown, Huerta Goldman, Lockhart, Renouf and Zdouc). As Huerta Goldman points out, having sufficient data available is important not only for WTO arbitrators, but also (if not more so) for the retaliating country itself to enable that country to calibrate an optimal retaliation package ('A policy maker considering the selection of goods to be subject to retaliation is handicapped if he or she does not have a comprehensive set of trade data available.'). Lockhart, pointing to the problem of the strict time frame within which arbitrators must finish their work (in principle, sixty days only), suggests that in order to improve the flow of information to arbitrators the parties should be given 'more time to address … concerns regarding methodologies and data' and arbitrators should be pushed to 'pose a first set of questions to the parties for written answer *before* the hearing' (instead of holding

these questions until the hearing). In Lockhart's view, 'if the arbitrators do not receive satisfactory answers, they should have the courage to draw adverse inferences and apply the burden of proof rigorously'. For Renouf, a WTO official acting regularly as legal adviser to WTO arbitrators, '[t]he cooperation of the parties in providing data is … essential and all arbitrators have insisted on the need for parties to provide the latest and most accurate data available. Arbitrators sometimes went as far as threatening to use publicly available (and presumably less accurate) data if the parties were not forthcoming' (Renouf here refers to *Canada–Aircraft*).

Kaufmann-Kohler's conclusion on the capacity of arbitrators to calculate damages in the investment context (notwithstanding increasingly high levels of complexity) does send a hopeful message for WTO retaliation calculations. In her view, 'practice shows that with a fair level of discretion in the choice of the methodology and valuation techniques and an increasing measure of expert assistance, investment arbitrators are in a position to assess direct compensation'. The sophisticated modelling and calculation of trade effects in *US–Byrd Amendment*, for example, is generally referred to as a big step forward and an example for future cases. To use Renouf's terms, arbitration an WTO retaliation 'has grown up' and is 'coming of age'. Our hope is that this volume will further nurture this learning process.

PART I

Background and goal(s) of WTO retaliation

1

The nature of WTO arbitrations on retaliation

GIORGIO SACERDOTI

1 Novelties in the WTO dispute settlement system

The dispute settlement system established by the WTO Agreement and set forth in the Dispute Settlement Understanding (DSU) is one of the major achievements of the Marrakesh Agreement of 1994. The establishment of what is in substance a compulsory and exclusive third-party adjudication based on law to settle all disputes arising under the WTO Agreement and its annexes among the WTO members is a key feature of the 'rule-based' WTO, as opposed to the more soft and 'power-based' GATT. At the same time the mechanism did not go as far as full judicialization: it resorts to a combination of diplomatic means (the initial consultations), arbitral and judicial organs (the panels and the Appellate Body) and the bestowing of overall and final responsibility upon the political organs of the WTO, mainly the Dispute Settlement Body (DSB) within a strictly defined mandate ('automatic' adoption of the reports).

There are two other novelties worth underlining. The first is that this system is unique among specific regimes established to govern definite sectors of international relations beyond regional arrangements. The law of the sea regime as governed by the UNCLOS Convention of 1982 includes a court, that is, the Tribunal of the Law of the Sea. Its competence is, however, quite limited and there is no obligation for the parties to the Convention to resort to its jurisdiction except for narrowly defined types of disputes.

The second feature, which is more central to our examination and discussion, concerns the implementation of the decisions of the panels and the Appellate Body, once adopted by the DSB. Implementation of binding international decisions, be they issued by political institutions or by judicial organs, has always been the Achilles' heel of the international order, undermining the operation of international justice. Faced with a

recalcitrant obligee, the pendulum swings between resorting to coercive measures – a momentous choice often not practicable – and leaving the responsibility to comply to that very party, with the risk that effectiveness of the legal order becomes a mockery.[1]

The WTO has dealt with these problems through a complex system that relies on various elements:

(1) first, the willingness and cooperation of the party which must comply with a decision, on the assumption that trade obligations (which should not be loaded in principle with political sensitivity) will be carried out spontaneously in good faith;
(2) mutual agreement between this party (the 'losing' party) and the 'winning' party, in order to facilitate compliance or develop alternatives such as compensation;
(3) pressure put upon the losing party by the continuous multilateral surveillance of implementation by the DSB;
(4) flexibility resulting from the fact that implementation entails the removal of the objectionable conduct and withdrawal of domestic measures in conflict with a WTO obligation only for the future (*ex nunc*, not *ex tunc*) without any obligation to pay damages for past breach;
(5) and, finally, recourse to compulsory third-party adjudication if key steps in the implementation phase should be blocked by disagreement.

This last element is also novel and is an integral element of the objective to obtain effective compliance, removing the loss of trade, basically the prejudice caused to the market access guaranteed and expected by the other trading partner(s). As a last remedy, this includes authorizing trade sanctions in the form of countermeasures offsetting the prejudice suffered by the winning party. They are allowed as long as non-compliance persists and in proportion to such prejudice. However, suspension, that is countermeasures, result in a lose–lose game, while trade negotiation and commitments aim at producing a win–win situation in international trade. They are a second-best solution, and it is, therefore, a euphemism to state that they lead to 'rebalancing mutual trade benefits', albeit at a lower level.[2] Their purpose is in any case to induce compliance; the ultimate aim remains the removal of the inconsistent restriction (Article 22.1, DSU).

[1] J. G. Merills, *International Dispute Settlement*, 3rd edn. (Cambridge, 1998), 117.
[2] See WTO, *A Handbook on the WTO Dispute Settlement System* (Cambridge University Press, 2004), 81.

2 Third-party adjudication in the DSU implementation phase

Recourse to third-party adjudication is provided in a number of instances in the implementation phase. First, Article 21.3, DSU provides that if immediate compliance is impracticable and the parties in dispute do not agree a reasonable period of time to comply, such period shall be determined by binding arbitration.

Secondly, where there is disagreement as to the existence or consistency with a WTO agreement of measures taken to comply with the recommendations and rulings of the DSB, Article 21.5, DSU provides for recourse to the original panel, with the possibility of appeal to the Appellate Body.

Thirdly, under Article 22, DSU, if proper compliance is not effected within such reasonable period of time, upon request of the winning party the DSB shall authorize suspension of concessions or other obligations under the WTO Agreement, that 'shall be equivalent to the level of the nullification or impairment' caused to the party that makes the request. The granting of the authorization by the DSB is ensured by the 'reversed consensus' that applies when the DSB is so requested. To ensure the equivalence between sanctions imposed and prejudice caused, since the level of suspension is proposed by the winning party, compulsory arbitration is mandated by Article 22.6 in case of challenge by the other party in order to prevent 'overshooting'. Article 22.7 makes this explicit where it states that the task of the arbitrator(s) is to 'determine whether the level of such suspension is equivalent to the level of nullification or impairment'. This arbitration, to be entrusted to the original panel with no possibility of appeal, was the main object of the Workshop that led to the present volume. I will accordingly focus on some legal features of this mechanism, considering it within the framework of the other third-party adjudication procedures, highlighted above, which are provided within implementation.

I wish to recall that resort to these mechanisms has been rather frequent, a practice that confirms the success of the whole dispute settlement system and its centrality as a key element of the functioning of the multilateral rule-based trade system of the WTO. From 1995 to the end of 2008 there have been twenty-eight arbitrations on the length of the reasonable period of time under Article 21.3, all of which were carried out by individual arbitrators chosen by the Director-General from among the past or current Appellate Body members.[3] There have been twenty-eight panel

[3] For the complete list of arbitrations from 1995 to 2008 see *Appellate Body Annual Report 2008* (WTO, 2009), 89ff.

proceedings to resolve disputes on the correctness of compliance under Article 21.5 (of which fifteen have resulted in appellate proceedings), with a substantial increase in recent years. Finally, there have been seventeen arbitrations on the level of concession to be suspended.[4]

Within the WTO, binding arbitration in order to settle disputes concerning market access has also been resorted to beyond the DSU. Specifically the 'banana waiver', granted to the EC by the Ministerial Conference at Doha in 2001 in favour of the African, Caribbean and Pacific (ACP) countries in accordance with Article IX:3 of the WTO Agreement, provided for two arbitrations in case of dispute concerning the maintenance of the previous 'total market access for MFN banana suppliers' to the EC.[5] In fact, both arbitrations took place in 2005–2006, although they failed to resolve the dispute.[6]

3 WTO arbitrations during the implementation phase: legal versus non-legal disputes; lawyers versus non-lawyers

The legal question which I would like to address concerns the nature of these arbitrations since they present some novel features in the panorama of international arbitration and judicial settlement, especially that provided by Article 22.6.

Since the development of arbitration based on due process and the application to the substance of the dispute of legal rules and principles of international law in the second half of the nineteenth century, this method of interstate dispute settlement has been considered appropriate to deal with 'legal disputes', thereby deciding who is right and who is wrong. Arbitration of this kind, on the other hand, has been considered inappropriate for settling 'political disputes' because of their sensitivity and/or the absence of pre-existing rules on the basis of which they could be resolved. Political disputes have been considered the province of negotiation and agreement, through mediation, diplomacy, equitable

[4] For the complete list of Article 21.5 Panel proceedings and arbitrations from 1995 to 2007 see 'Dispute Settlement Body, Annual Report 2007, Overview of the State of Play of WTO Disputes', WT/DSB/43/Add.1. Available at: www.wto.org.

[5] See Doha Ministerial Conference, The ACP–EC Partnership Agreement Decision of 14 November 2001, Annex I.

[6] See Award of the Arbitrator, *EC–The ACP–EC Partnership Agreement*, Recourse to Arbitration Pursuant to the Decision of 14 November 2001, WT/L/616, 1 August 2005 (DSR 2005:XXIII, 11667); Award of the Arbitrator, *EC–The ACP–EC Partnership Agreement*, Second Recourse to Arbitration Pursuant to the Decision of 14 November 2001, WT/L/625, 27 October 2005 (DSR 2005:XXIII, 11701).

solutions and decisions by competent organs of international organizations. There is a long tradition at the root of this distinction.[7] Let me recall here in Geneva the statement of one of the founding fathers of the doctrine of international law, the Swiss jurist, de Vattel, in the middle of the eighteenth century in his treatise *Le droit des gens*: 'Arbitration is a most reasonable instrument to settle a dispute and most in conformity with natural law, provided that the dispute does not directly affect the preservation of the Nation.'[8]

More recently, when institutional arbitration and judicial proceedings have largely replaced ad hoc arbitration, this principle is set forth in Article 36.3 of the UN Charter dealing with Pacific Settlement of Disputes: 'In making recommendations under this Article the Security Council should also take into consideration that legal disputes should as a general rule be referred by the parties to the International Court of Justice in accordance with the provisions of the Statute of the Court.' This reflects the fact that under Article 36.2 of the latter the court is competent in respect of 'legal disputes'.

The criteria to distinguish a legal dispute from other types of disputes are far from clear and undisputed. Basically, a legal dispute is one where the claimant bases its claim on a right to which it argues it is entitled based on a legal provision binding the other party, which the claimant complains has been breached by such other party.[9] A legal standard must exist against which the alleged breach can be evaluated so that the conduct of the respondent may be labelled as unlawful, if so proved in fact and in law. By contrast, in a political dispute the claimant does not base itself on a legal entitlement but relies on arguments of political expediency, security needs, economic satisfaction, of moral or other nature. In such a dispute, the claimant often relies on principles generically recognized by the legal order though running counter to an existing legal regulation (such as invoking the right of self-determination of peoples to modify a border agreed by treaty). A political pretension may thus aim at changing the legal situation and may be unfounded in strict legal terms.

[7] See G. Morelli, 'La théorie générale du procès international', *RC*, 61 (1937: III), 253–373; A. Cassese, 'The Concept of "Legal Dispute" in the Jurisprudence of the ICJ', *Comunicazioni e Studi*, vol. XIV (Milano, 1975), 173ff; C. Santulli, *Droit du contentieux international* (2005), 4.

[8] Emmerich de Vattel, 'De l'Arbitrage', *Le Droit des Gens*, vol. II, para. 329.

[9] See also Publications of the Permanent Court of International Justice, Series B, No. 3, 1924; PCIJ, Series A, No. 2; *The Mavrommatis Palestine Concessions* case, where the classical definition of legal dispute is found. Accordingly, '[a] dispute is a disagreement on a point of law or fact, a conflict of legal views or of interests between two persons'. *Ibid*., 6.

But a grey area subsists. Legal disputes can be resolved though diplomatic means by mutual concessions. Decisions *ex aequo et bono* may settle both legal and non-legal disputes. Procedural justice, due process in the proceedings, appointment of jurists as arbitrators are indices of a legal dispute, but are not incompatible with the settlement of other types of controversy. An international tribunal may be empowered to settle any dispute under well-defined terms of reference.[10] The preference expressed recently in some fora for conciliation, rather than resorting to formal adjudication, may be aimed at overcoming the very distinction in the interest of an effective settlement of a dispute that one party may view as legal and the other as political. Alternatively, formal adversarial proceedings based on the application of international law to the dispute may not result in a binding decision, but rather in a recommendation that is subsequently incorporated into an authoritative decision of a political organ of the organization to which the proceedings pertain. This is the case with regard to panels and the appellate mechanism at the WTO, a feature that does not rule out at the outset the judicial nature of those proceedings.[11]

I believe that the distinction between legal and non-legal disputes is still valuable, even beyond an Aristotelian logic. Determining whether a dispute has a legal character may be relevant for jurisdictional purposes, helps in organizing dispute settlement mechanisms that are consistent with the nature of the disputes to be resolved, assists in pinpointing the obligations that are at stake, the content of any decision and what compliance entails. The various WTO mechanisms in the implementation phase show an expansion of the category of legal disputes amenable to third-party adjudication – arbitration and judicial – beyond the traditional realm.

The expansion of international law and dispute settlement mechanisms into new realms has added interest to the issue. Norms refer more and more to non-legal standards that become direct or indirect content of, or parameters relevant to determine the content of, international obligations, just as is current in domestic law and litigation or in commercial arbitration. The judge and the arbitrator are called upon to decide what is

[10] See the competence that may be bestowed upon the European Court of Justice to settle as an arbitrator disputes between member states of the EU under Article 239 of the EC Treaty.

[11] See, in general, our contribution 'The Dispute Settlement System of the WTO in Action: A Perspective of the First Ten Years' in G. Sacerdoti, A. Yanovich and J. Bohanes (eds.), *The WTO at Ten – The Contribution of the Dispute Settlement System* (Cambridge University Press, 2006), 42ff.

the applicable non-legal standard of human conduct and whether such a standard has been complied with or not; the legal consequence may be just a mechanical follow-up.[12] Medical malpractice cases, disputes concerning technical standards to be applied in public works, manufacturing, provision of services are good examples. In domestic legal orders questions of life or death (for the accused) may be entrusted to juries of laymen and women.

The law itself, including international law, refers to standards of conduct which must be applied in the light of circumstances and where precedents fulfil an important role: thus, in the area of protection for foreign investors and ensuing litigation, the fair and equitable, reasonable and other standards of conduct applicable to host governments. Finally, establishing damages caused by the breach of an obligation entails mostly non-legal, but rather technical, accounting, economic determinations and estimates. Nonetheless, this is recognized as an integral part of litigation and arbitration, both domestically and internationally, in private and interstate disputes.

The legal profession has by and large maintained its competence to decide these issues; lawyers are more commonly chosen to perform the task of assessing damages than accountants, engineers or other professionals. Judges and arbitrators, of course, rely heavily on experts in order to discharge their mandate in this respect, but maintain the last word: *judex peritus peritorum*, the judge is the expert among the experts. The set up and practice of WTO panels is consistent with this approach.[13]

In the light of the above framework how should we view the various arbitration proceedings envisaged by the DSU in the implementation phase? As to disputes under Article 21.5 concerning implementation of a previous panel or Appellate Body adopted report, there is no doubt that the dispute shares the same legal nature as the original case. The task of the adjudicators is to decide the conformity of a measure taken to comply with the previous holding and generally with WTO obligations. This is a typical legal operation entailing interpretation of both the domestic measures and WTO law. It is not by chance that the report of an Article 21.5 panel may be appealed to the Appellate Body, which in this respect exercises its usual functions: namely, to review the issues of law covered

[12] *Cf.* Article 36.2(c) of the Statute of the ICJ under which the court may be given competence in respect of 'the existence of any fact which, if established, would constitute a breach of an international obligation'.

[13] See Article 13 DSU, 'Right to seek information': 'Each panel shall have the right to seek information and technical advice by any individual or body which it deems appropriate.'

in the panel report and legal interpretations developed therein that have been appealed and uphold, modify or reverse the panel's legal findings and conclusions.

The characterization of arbitration under Article 21.3 for determining the reasonable period of time for implementation is more complex. No determination of non-compliance is at issue here, nor any determination of fact that may be relevant to ascertain who is right and who is wrong. The task of the arbitrator is to make declarative and prospective determination, applying *in casu* the right accorded to the losing party, spelled out in that provision: that of having a reasonable period of time to comply.[14]

At this point one may wonder whether this a discretionary determination by the arbitrator, similar to an *aequo et bono* decision, although even such a decision is not to be equated to arbitrariness and requires the expression of grounds. 'Reasonable' in the light of what? And in the interest of whom? Article 21 supplies fundamental criteria in this respect: first, 'prompt compliance with recommendations or rulings of the DSB is essential in order to ensure effective resolution of the disputes to the benefit of all Members' (Article 21.1). Secondly, 'a guideline for the arbitrator should be that the reasonable period of time to implement panel or Appellate Body recommendations should not exceed 15 months from the date of adoption of a panel or Appellate Body Report. However, that time may be shorter or longer, depending upon the particular circumstances' (Article 21.3(c)).

In practice the yardstick has been the time needed to adopt the implementing measure by the member that has to comply, considering the length of the domestic proceedings required. More precisely several arbitrators have held that 'the reasonable period of time, as determined under Article 21.3(c), should be the shortest period possible within the legal system of the member to implement the recommendations and rulings

[14] See on Article 21.3, 'arbitration': Alvarez-Jiménez Alberto, 'A Reasonable Period of Time for Dispute Settlement Implementation: An Operative Interpretation for Developing Country Complainants', *World Trade Review*, 6:3 (2007), 451–76; Gambardella Maurizio and Rovetta Davide, 'Reasonable Period of Time to Comply with WTO Rulings: Need to Do More for Developing Countries?', *Global Trade and Customs Journal*, 3:3 (2008); Monnier Pierre, 'The Time to Comply with an Adverse WTO Ruling: Promptness with Reason', *Journal of World Trade*, 35:5 (2001), 825–45; Peng Shin-yi, 'How Much Time is Reasonable? – The Arbitral Decisions under Article 21.3(c) of the DSU', *Berkeley Journal of International Law*, 5 (2008); Zdouc Werner, 'The Reasonable Period of Time for Compliance with Rulings and Recommendations Adopted by the WTO Dispute Settlement Body' in R. H. Yerxa and S. B. Wilson (eds.), *Key Issues in WTO Dispute Settlement: The First Ten Years* (Cambridge University Press, 2005).

of the DSB'.[15] Thus, the deadline has been shorter when administrative action was required, in contrast to instances where legislative measures are indispensable. The period granted has varied between six and fifteen months.[16]

Notwithstanding the accumulated precedents and the parties' input have in the proceedings (including briefs and a hearing), the arbitrator enjoys a substantial degree of discretion. His or her tasks are not typical of an arbitrator in a legal dispute; rather, they are more akin to those of an expert entrusted with the completion of an element of a contract, such as to determine the 'fair market value' of an asset in a sale. The fact that the Director-General has up till now always appointed former or current members of the Appellate Body, supported by members of the Appellate Body's Secretariat, indicates the importance of entrusting with such a sensitive task (the decision is final in all respects, not subject to review or adoption) experienced and prudent senior figures, well acquainted with the system.

4 Specific features of WTO arbitration on the level of retaliation

I come now to the Article 22.6–7 arbitration for determining the equivalence between the level of nullification or impairment of benefits caused by a WTO-inconsistent measure not withdrawn by the non-complying party, on the one hand, and the level of concessions that the winning party proposes to suspend, on the other hand.

It must be recalled that it is the winning party that proposes the suspension of certain concessions, usually in the form of an increase in custom duties on exports from the non-complying party. The task of the panel in arbitration is then to determine whether the negative effect of that increase on those exports will be equivalent to the prejudice caused by the restriction in the opposite direction that has been maintained in breach of its WTO obligations by the other party. Thus, the comparison is between an actual and prospective loss of trade (in respect of the hypothetical situation had the measure been withdrawn), on the one hand, and the prospective trade loss that the retaliation is likely to cause. It is

[15] Award of the Arbitrator, *Canada–Pharmaceuticals Patents*, para. 45, WT/DS114/13, 18 August 2000 (DSR 2002:I, 3).

[16] For details, see *WTO Appellate Body Repertory of Reports and Awards 1995–2006* (Cambridge University Press, 2007), 880ff.

clear that competence in trade, economy, statistics, consumer behaviour, price elasticity and products substitution is called for. Although the DSU is silent in this respect, recourse to experts by the arbitrators, as panels are authorized to do under Article 13 DSU, should be possible. Such a possibility should be welcome, because it might supplement the material that the litigants themselves may supply. Since the original panel members are chosen as arbitrators, if available, it is apparent that they may well lack the competence that would be required. No appeal is envisaged in these proceedings. This confirms that the subject matter was viewed as involving predominantly non-legal issues, considering that the Appellate Body is competent to review the panel decisions in order to correct legal errors.[17]

In my view, the task of panels acting as arbitrators under Article 22 can be assimilated to the determination of future damages, specifically loss of profits (*lucrum cessans*) in commercial disputes as a consequence of breach of contract, or of unlawful state action in foreign investors' disputes against the host state under investment protection treaties. There are established rules, though not undisputed, for valuation of different types of productive assets, as well as for future losses (as discussed in the contribution by Kaufmann-Kohler, see Chapter 24). The use of one or another parameter, such as the discount rate for future cash flows, may bring considerable differences in the results. Valuation experts are usually relied upon by judges and arbitrators, since the latter recognize their lack of competence in this respect, except when valuers or accountants are themselves appointed to decide. A common feature in all such disputes is that the losses are measured and, hence, the damages are liquidated in monetary terms.

At the WTO the losses, mostly prospective, are instead measured in monetary terms, but the damage suffered is somehow liquidated in kind: namely, the creditor may inflict an equivalent loss on the liable party by suspending a trade concession of an equivalent value. This, however, entails the additional difficulty of estimating what loss will be caused in the future by the retaliation: namely, by the authorized increase in certain tariffs on imports from the non-complying party.

[17] Determining damages is in any case a proper object of a legal dispute. See Article 36.2(d) of the Statute of the ICJ, listing among the legal disputes on which the court may be given jurisdiction 'the nature and extent of the reparation to be made for the breach of an international obligation'.

A careful examination of all issues involved, including evaluating past cases and discussing possible improvements, is therefore timely and appropriate, especially in view of the limited attention devoted to these issues up to now, notwithstanding their importance. The launching of this interdisciplinary Workshop and the present volume is, therefore, most welcome.

2

The calculation and design of trade retaliation in context: what is the goal of suspending WTO obligations?

JOOST PAUWELYN

> [I]t is not completely clear what role is to be played by the suspension of obligations in the DSU and a large part of the conceptual debate that took place in these proceedings could have been avoided if a clear 'object and purpose' were identified. (*US–Byrd* arbitration, paragraph 6.4)

1 Introduction

This volume concerns the calculation and design of trade retaliation in response to continued non-compliance with the WTO treaty. In subsequent chapters, detailed questions related to this broad topic are examined. One red line that frequently runs through these assessments of legal or economic detail (be it the application of the 'equivalence' standard, the choice of 'counterfactual',[1] the benchmark to determine 'nullification'[2] or the selection of products to target[3]) regards the purpose or goal(s) of suspending WTO concessions. When the WTO permits, or a WTO member engages in, trade retaliation in response to continued non-compliance, what is it trying, or can it legitimately hope, to achieve? This question, as we examine it here, does not relate to what the *retaliating country's* preferences are in this situation (obviously, as complainant, its first goal is most likely to be compliance by the defendant). The question is rather what the drafters of the Dispute Settlement Understanding (DSU) as a whole (drafting

[1] See Thomas Sebastian, 'The Law of Permissible WTO Retaliation', Chapter 4, section 3(a)(i), below.

[2] See Simon Schropp, 'The Equivalence Standard under Article 22.4, DSU: A "Tariffic" Misunderstanding?', Chapter 20, section A, below.

[3] See Håkan Nordström, 'The Politics of Selecting Trade Retaliation in the EC: A View from the Floor', Chapter 10, below.

as both potential complainants *and* potential defendants) intended with the instrument of WTO retaliation. Although clarification of this purpose or goal surely does not solve all problems, nor is it able to provide exact numbers,[4] it can offer crucial insights as a contextual element.

To thus put the calculation and design of trade retaliation in context, this chapter attempts to clarify the goal(s) of WTO suspension from both an historical, descriptive perspective (what has been and currently is the goal of GATT/WTO suspension?) and a prescriptive, normative point of view (ideally, what should be the goal of WTO suspension?). This will be done mainly for the calculation (or *quantity*) aspects of trade retaliation, but will have repercussions also on questions of design (or *quality*).

First, when it comes to the permitted level or quantity of WTO suspensions (how many US$ per year?), WTO rules impose a multilaterally controlled 'equivalence' standard, that is, suspensions cannot go beyond what is 'equivalent' to the level of nullification or impairment caused by the original violation.[5] Notwithstanding this, at first sight, rather strict and clear standard of 'equivalence', ample 'wiggle room' remains to interpret and apply this standard in the light of its goal or 'object and purpose' as called for in the rules of treaty interpretation of the Vienna Convention on the Law of Treaties (incorporated also in the WTO through Article 3.2 of the DSU).

Second, as regards the design or quality of WTO suspensions (which products should be targeted, at what level of additional duty and for how long?), WTO rules leave most of the decisions (with the exception of some limits on cross-retaliation[6]) to the discretion of the retaliating country. As the arbitrators in *EC–Hormones* put it: '*qualitative* aspects of the proposed suspension touching upon the "nature" of concessions to be withdrawn … fall outside the arbitrators' jurisdiction'.[7] Yet, when making those decisions, retaliating countries will most likely be guided by what they perceive to be the purpose or goal of the suspension in the particular case at hand. Hence, at this level as well – and possibly more so than at the calculation level where the legal confines are stricter – the question of the goal or purpose of WTO suspension matters.

[4] As pointed out by Thomas Sebastian in his contribution to this volume, 'The Law of Permissible WTO Retaliation', Chapter 4, section 7.

[5] Article 22.4, DSU.

[6] These limits are set out in Article 22.3, DSU.

[7] *EC–Hormones*, Decision by the arbitrators under Article 22.6, DSU, WT/DS26/ARB (DSR 1999:III, 1105), WT/DS48/ARB (DSR 1999:III, 1135), para. 19 (original emphasis).

This chapter concludes that the goal of multilaterally controlled GATT/WTO suspension has historically been, and remains to this day, murky and confused (ranging from simple rebalancing of concessions to punishment). Yet, if anything, there has been a gradual evolution from 'compensation' (or simple rebalancing) to 'sanction' (or rule compliance). Hence, instead of one goal, there seem to be multiple and sometimes overlapping goals. Since retaliation for continued non-compliance is, in practice, the only formal remedy provided for by the system (compensation for past harm is not awarded), all possible cures seem to be expected from it. From a normative perspective, however, the argument will be made that this flexibility in the goals pursued by trade suspension, when carefully calibrated, can be a good thing. Although certain perceived goals (such as full compensation of all victims or outright punishment) cannot possibly be met with the current purely prospective 'equivalent retaliation' instrument, the case will be made that different types of legal entitlements should be matched with different types of protection and enforcement goals (referred to as liability rules, property rules and inalienability). Rather than one fixed goal of WTO suspension, there are (and should be) several possible goals. Put differently, optimal protection of WTO entitlements implies variable protection of WTO entitlements.

2 What could be the goal(s) of WTO suspension?

Let us take the *EC–Hormones* case as an example. The United States wins the substantive dispute. Yet, because the EC does not implement the ruling within the set reasonable period of time and no compensation can be agreed on pursuant to DSU, Article 22.2, the United States obtains the right to suspend concessions 'equivalent' to the nullification or impairment caused to it by the EC hormone beef ban (*in casu*, US$116.8 million per year). When the United States subsequently imposes 100 per cent duties on selected EC imports (ranging from Italian scarves to French Roquefort cheese), what is the United States trying, or can it legitimately expect, to achieve? In other words, what is the goal of WTO suspension? As noted in the Introduction, what interests us here is not what *US* preferences are in this situation (obviously, as complainant, its first goal is most likely to be compliance by the EC). The question is rather what the drafters of the DSU as a whole (drafting as both potential complainants *and* potential defendants) intended with the instrument of WTO retaliation. Shaffer and Ganin (Chapter 3) do focus on the practice of retaliating countries to discern the overall purpose of WTO retaliation (namely,

in their view, inducing compliance). Yet, in doing so, they can, obviously, paint only part of the picture and not account for the practice or preferences of the victim of retaliation, that is, the original wrongdoer (who may well prefer mere rebalancing or compensation as much as the retaliator is likely to prefer compliance).

Two broad sets of goals could be pursued by trade retaliation, defined here as compensation versus sanction. First, by restricting EC imports, the United States could be authorized to, or seek to, obtain some form of compensation, broadly defined. By suspending some of its earlier granted trade concessions as against the EC, the United States would then reciprocate, rebalance the scales or return to the situation as it existed before the respective concessions were exchanged (reciprocal non-performance, return to the *status quo ante* or invocation of the so-called *inadimpleti non est adimplendum* exception). The retaliation could also compensate the United States in more precise, monetary terms: keeping out EC agricultural products, for example, may compensate US farmers, that is, alleviate the damage caused to the victims of the EC hormone beef ban. As a large country, US duties may also improve US terms of trade and thereby overall US welfare pursuant to the theory of optimal tariffs.[8]

Second, by restricting EC imports, the United States could be authorized or seek to impose some form of sanction, broadly defined, on the EC. This sanction could aim at inducing compliance or rule conformity by the EC or at least a bilateral settlement agreeable to the United States. Suspension as sanction could also go beyond the goal of rule compliance in the particular case and seek to impose punishment or deterrence as regards possible future violations.

The four possible goals of WTO suspension are depicted in Table 2.1 below. Note that the two types of 'compensation' (reciprocal withdrawal of concessions and compensating the victims of the original violation) focus on what happens in or with the *victim state*, here the United States. The goal of compensation, broadly defined, also seems to be the focus of most economists contributing to this volume.[9] In contrast, the two types of 'sanction' (inducing compliance and punishment) focus on changing

[8] See Fritz Breuss, 'A General Equilibrium Interpretation of some WTO Dispute Settlement Cases – Four EU–US Trade Conflicts', Comment on Chapter 20, below.

[9] See Chad Bown and Michele Ruta, 'The Economics of Permissible WTO Retaliation', Chapter 6, below, whose entire study is predicated on pure reciprocity; Alan Sykes, 'Optimal Sanctions in the WTO: The Case for Decoupling (and the Uneasy Case for the *Status Quo*)', Chapter 16, below, who regards WTO dispute settlement as aimed at efficient breach with retaliation acting as a compensation device. See also Simon Schropp,

Table 2.1. *The possible goals of WTO suspension*

I. Compensation (focus on victim)		II. Sanction (focus on violator)	
1. rebalance	2. damages	3. induce compliance	4. punishment

the situation in the *violating state*, here the EC. WTO suspension as sanction to induce rule compliance is (not surprisingly) the goal most often referred to by the lawyers contributing to this volume.[10] The same is true for WTO arbitrations on the question[11] and retaliating complainants actually imposing WTO suspensions (yet, as noted earlier, what retaliating countries aim for must be distinguished from what the drafters of the DSU intended to be the goal of WTO suspension and what, as a result, WTO suspension can realistically be expected to achieve).[12]

3 Why does the goal of WTO suspension matter?

As pointed out in the Introduction, the goal of WTO suspension matters for both the calculation and the design of trade retaliation. This section, while not being exhaustive in any way, lists a number of areas where the intended goal of WTO suspension may have a material impact.

First, when arbitrators are asked to decide on the permitted *level* of retaliation pursuant to the equivalence standard in DSU, Article 22.4, they may come up with a higher number if they perceive the goal of the retaliation to be 'sanction' than if they are of the view that the goal is mere 'compensation'.[13] Put differently, inducing compliance or punishment

'The Equivalence Standard under Article 22.4, DSU: A "Tariffic" Misunderstanding?' and Fritz Breuss, 'A General Equilibrium Interpretation of some WTO Dispute Settlement Cases – Four EU–US Trade Conflicts'; both focusing on welfare and calibrating WTO remedies, including trade retaliation, so as to achieve Pareto efficiency or expectation damages.

[10] See William Davey, 'Sanctions in the WTO: Problems and Solutions', Chapter 17, below and Reto Malacrida, 'WTO Retaliatory Measures: the Case for Multilateral Regulation of the Domestic Decision-making Process', Chapter 18, below, as well as the discussion in Thomas Sebastian, 'The Law of Permissible WTO Retaliation', Chapter 4, below.

[11] See section 6, below.

[12] As reflected in the contributions to Part IV of this volume on the politics of selecting and implementing trade sanctions.

[13] For instance, in *Canada–Export Credits and Guarantees*, the arbitrators adjusted the result of the calculation based on the amount of the subsidy by 20 per cent in order to

may necessitate a *higher* level of retaliation than merely rebalancing the bargain.

Second, the goal of WTO suspension may influence what is taken as the *benchmark* to calculate the amount of *nullification* caused by the original violation as well as the amount of *retaliation* authorized in response. If the goal is to compensate the victims of the violation (for example, US farmers harmed by the EC ban on hormone-treated beef), then the most appropriate benchmark to assess nullification may well be the economic harm or loss of profits suffered by the victims of the violation (as, for example, advocated by Schropp (Chapter 20), who sees the goal of retaliation as 'to compensate the Complainant for its true damage from the violation of the contract'[14]). If, in contrast, the goal of the suspension is to restore the broader balance of trade concessions between the two countries, then a more appropriate benchmark could be the trade effects or value of lost bilateral trade caused by the violation (to be distinguished from the actual economic harm caused by the violation). Similarly, if the goal of retaliation is rebalancing then the retaliation could be set at an equivalent 'level of trade', instead of an equivalent 'monetary level of compensation' (for example, a prohibitive tariff keeping out as much trade as the original violation, as is the case in practice so far, instead of, for example, adding up tariff revenues up to the total amount of harm caused by the original violation).

Third, if the goal of WTO suspension is seen as sanctioning the violator to induce compliance, then the retaliating country would be well-advised to retaliate against those sectors and products where the violating country will be hurt the most (for example, politically-sensitive products or suspension of intellectual property rights). In contrast, if the goal of the suspension is to compensate the victims of the original breach, then the retaliating country would be better advised to retaliate against those sectors or products that compete with its domestic industry, especially the industry harmed by the original violation (for example, EC agricultural products kept out of the United States in *EC–Hormones*). Similarly, Nordström's proposal[15] of retaliation in the form of a 2 per cent additional

cause Canada to reconsider its position, which was then to maintain the subsidy in breach of its obligations. See *Canada–Export Credits and Guarantees*, Decision by the arbitrator under Article 22.6, DSU and Article 4.11, SCM Agreement, WT/DS222/ARB (DSR 2003:III, 1187), paras. 3.119–22.

[14] Simon Schropp, 'The Equivalence Standard under Article 22.4, DSU: A "Tariffic" Misunderstanding?', section A.

[15] See Håkan Nordström, 'The Politics of Selecting Trade Retaliation in the EC: A View from the Floor'.

tariff on a wide range of products makes more sense if the goal is compensation (including improving one's terms of trade with an optimal tariff), than when the objective is to sanction or induce compliance (a 2 per cent tariff on a wide range of products is likely to have less of a punishment or inducement effect than prohibitive, 100 per cent duties on politically-sensitive products).

Fourth, the goal of WTO suspension may also guide questions of timing. If the goal is compliance, then there would be good reason to start calculating the level of nullification and corresponding retaliation as of the date of enactment of the illegal measure or, at least, as of the date of adoption of the WTO ruling finding the measure to be WTO inconsistent.[16] If, in contrast, the goal is simply to rebalance concessions or compensate during the time of continued non-compliance, a later starting point could be chosen. Similarly, a so-called 'carousel' practice where the list of products against which sanctions are imposed is altered every six months may fit well with the goal of inducing compliance (the chilling effect related to the regular change is likely to keep out more trade); the justification for a 'carousel' practice is less clear when the goal is simply to rebalance or compensate.

Fifth, one of the preconditions to cross-retaliate, that is, to retaliate, for example, under the TRIPS Agreement in response to a violation under GATT, is that it is 'not practicable or *effective* to suspend concessions or other obligations with respect to the same sector' or 'the same agreement',[17] in our example, GATT. In *US–Gambling*, the arbitrators interpreted the question of whether suspension is 'effective' as follows:

> the thrust of the 'effectiveness' criterion empowers the party seeking suspension to ensure that the impact of that suspension is strong and has the desired result, namely to induce compliance by the Member which fails to bring WTO inconsistent measures into compliance with DSB rulings within a reasonable period of time.[18]

In other words, whether or not a WTO member has the right to cross-retaliate depends in part on the goal of WTO suspension: if the goal is simply to rebalance trade concessions then retaliation in the same sector

[16] As proposed by William Davey, 'Sanctions in the WTO: Problems and Solutions', section 3.

[17] Article 22.3(b), (c), DSU.

[18] *US–Gambling*, Decision by the arbitrator under Article 22.6, DSU, WT/DS285/ARB, para. 4.29, referring to *EC–Bananas (Ecuador)*, Decision by the arbitrators under Article 22.6, DSU, WT/DS27/ARB/ECU (DSR 2000:V, 2237), para. 72.

or agreement is more likely to be 'effective' (so that cross-retaliation is *not* allowed), than when the goal is to induce compliance (as the arbitrators in *US–Gambling* found, leading them to allow Antigua to cross-retaliate against the United States).

Finally, any assessment of the effectiveness of the WTO dispute settlement system more generally depends on what one regards as the goal of WTO suspension and WTO dispute settlement more broadly. Without fixing this goal or benchmark, any debate on effectiveness of the system is meaningless, with some authors[19] saying that WTO remedies are 'too weak', others[20] saying that they are 'too strong' and yet others[21] concluding that they are 'about right'. More specifically, if the goal is to rebalance concessions, then continued non-compliance in, for example, *EC–Bananas*, *EC–Hormones* and *US–Gambling* combined with reciprocal suspensions by the winning party, should not be seen as failures of the system. In contrast, if the goal is set at inducing compliance or rule conformity then those cases are examples of where the system has (not yet?) achieved its objective.

4 How can we figure out the intended goal(s) of WTO suspension?

Given the multiple options (section 2, above) and the importance of the question (section 3, above), how then can we answer the descriptive question of what is now the intended goal of WTO suspension?

First, we could engage in reverse engineering and based on the *level* of permitted retaliation deduce the implied *goal* of retaliation and WTO dispute settlement more generally. Sykes, for example, looks at the current rule that WTO suspension must be 'equivalent' to the nullification caused, to conclude that the intended goal of WTO suspension is mere rebalancing and that the underlying objective of WTO dispute settlement more generally is 'efficient breach'.[22] Put differently, if WTO members wanted WTO suspension to genuinely induce compliance, Sykes argues,

[19] See, for example, Petros Mavroidis, 'Remedies in the WTO Legal System: Between a Rock and a Hard Place', 11 *European Journal of International Law* (2000), 763.

[20] See, for example, Steve Charnovitz, 'Rethinking WTO Trade Sanctions', 95 *American Journal of International Law* (2001), 792.

[21] See Alan Sykes, 'Optimal Sanctions in the WTO: The Case for Decoupling (and the Uneasy Case for the *Status Quo*)'.

[22] See Alan Sykes, 'Optimal Sanctions in the WTO: The Case for Decoupling (and the Uneasy Case for the *Status Quo*)'.

they would have allowed retaliation to go beyond mere 'equivalence'. The fact that they put the ceiling at 'equivalence' implies that WTO members wanted simply to rebalance the scales and avoid punitive retaliation[23] (something *smaller* or *developing* countries have always been afraid of), and wanted to keep some flexibility to deviate from the rules where such was politically or otherwise expedient (a door that especially *large* or *developed* countries were glad to leave open). As noted below, however, some caution is warranted when engaging in such reverse engineering. The objective of WTO dispute settlement may be achieved not only by the formal remedy of (equivalent) retaliation but also by informal remedies, such as reputation and community costs. If so, the goal of WTO dispute settlement may go beyond what can be expected from 'equivalent' suspension alone, that is, it may nonetheless be to induce compliance rather than merely rebalancing the scales. The historical background, context and actual implementation of the equivalent retaliation standard all support this proposition (indeed, rule compliance follows in the huge majority of WTO disputes, and not a single WTO member has expressed the view that when it retaliates it merely seeks compensation and no longer expects compliance).

Second, we could figure out the goal of WTO suspension by examining the historical background and evolution of trade retaliation in the GATT/WTO. In this process, we could compare with, and draw lessons from, suspension or countermeasures in general international law. This exercise is conducted in section 5, below.

Third, and perhaps most relevant to practice, we could consider what arbitrators say is the intended goal of WTO suspension. As explained below (in section 6), however, the message is mixed and confused (although there seems to be a majority view that the goal is to 'induce compliance').

Fourth, we could consider what retaliating countries themselves have said is their goal when they retaliate, or look at how they designed their retaliation to learn more about what it is they are trying to achieve (for example, where they impose 100 per cent duties on a select list of politically-sensitive products in the violating state, as the United States normally does, retaliating countries are probably first and foremost seeking

[23] This argument is based on Pieter Jan Kuijper's personal comments to the presentation of a draft of this chapter at the CTEI's Interdisciplinary Conference on the Calculation of Trade Sanctions, Graduate Institute of International and Development Studies, 18–19 July 2008.

to induce compliance; if, in contrast, they were to impose 2 per cent duties on products that heavily compete with their own domestic industries, then the aim is probably also, if not predominantly, to compensate some of their own producers). Yet, as repeatedly pointed out, the question of interest here is not so much what retaliating countries seek with WTO suspension (as complainants most likely seek compliance), but rather what the drafters of the DSU as a whole intended to be the legitimate goal of WTO suspension.

It may come as a surprise that after more than 60 years, the GATT/WTO has still not nailed down the intended goal of its core formal remedy. There is, however, an explanation. During the GATT days, suspension of concessions under GATT, Article XXIII was authorized only once (in 1952, in a case between the Netherlands and the United States). Because of the possibility of defendant countries blocking the establishment of panels and the adoption of panel reports, the situation of continued non-compliance after adoption of a GATT ruling simply did not arise: if compliance was seen as a problem, defendants would have long blocked the panel process and, if anything, complainants would impose unilateral trade sanctions without GATT approval (as happened regularly under section 301 of the US Trade Act). It is only with the abolishment of this veto and the establishment of the automatic WTO dispute settlement system that recalcitrant defendants could be pushed all the way against the wall of non-compliance and into an arbitration proceeding on levels of retaliation. Hence, it is only since 1995 that the question of multilaterally authorized trade retaliation and how to calibrate it arose.

5 The historical evolution of the goal(s) of trade suspension from GATT to WTO

The raw text of what the GATT/WTO allows in terms of trade retaliation has not always been set at 'equivalence' to nullification. GATT, Article XXIII:2, the precursor to DSU, Article 22.4 which sets out the current 'equivalence' standard, provided a more flexible benchmark, namely suspension as 'appropriate in the circumstances'. This 'appropriateness' standard seems to allow for retaliation that goes beyond mere 'equivalence'.[24] Put differently, and following the reverse engineering exercise hinted at earlier, whereas today's 'equivalent retaliation' would seem to imply a goal of mere rebalancing or compensation (*quod non*, as

[24] See the opinion of the GATT Legal Adviser referred to in note 31, below.

discussed below), 'appropriate retaliation' could lend itself to the more ambitious goal of sanction or even punishment. From this purely textual perspective, one could then think that there has been an evolution in the goal of multilaterally controlled GATT/WTO retaliation (to be distinguished from self-help or unilateral sanctions taken, for example, by the United States under Section 301 of the Trade Act) from 'sanction' in the GATT to mere 'compensation' in the WTO.[25]

When looking at the negotiating history of GATT and putting the GATT/DSU texts in context, however, if there is a trend to be discerned, it is one in the opposite direction. Indeed, if anything, and somewhat counterintuitively based on the texts alone, the movement from GATT to WTO has been one from regarding retaliation as aimed at rebalancing or compensation in GATT, to inducing compliance or sanction in the WTO.[26]

Let us first look at the negotiating history of GATT, Article XXIII:2. Some delegations wanted to provide for punitive sanctions so as to ensure compliance with the rules rather than simply rebalance the scales.[27] Yet, a Working Group examining the question in the context of the Havana Charter recommended that, even in the case of legal violation, the remedy should be compensatory suspension of concessions and no more.[28] As a result, in the final Havana Charter, the provision corresponding to GATT, Article XXIII:2 referred to suspensions that are 'appropriate *and compensatory*'. To clear all doubt, an interpretative paragraph stated that 'the nature of the relief to be granted is compensatory and not punitive' and that the word 'appropriate' should not be read to provide relief

[25] Note, moreover, that Article XXIII:2 permitted suspensions only if 'the circumstances are serious enough to justify such action'. In contrast, whenever a WTO member wins a dispute and the other party does not implement in time, the complainant has an automatic right to equivalent retaliation, even if, somehow, the circumstances were *not* 'serious enough'. In sum, retaliation in the WTO is allowed *more often* (no need for 'serious circumstances'), but, at least based on the text alone, at a *lower level* ('equivalent' as opposed to 'appropriate').

[26] In support see Steve Charnovitz, 'Rethinking WTO Trade Sanctions', 792.

[27] See Robert Hudec, *The GATT Legal System and World Trade Diplomacy* (New York: Praeger, 1975), 26–31; John Jackson, *World Trade and the Law of GATT* (Indianapolis, In: Bobbs-Merril, 1969), 169, note 21.

[28] United Nations Conference on Trade and Employment, 'Report of the Working Party 3 of Sub-committee G', E/Conf.2/C.6/W.80, 30 January 1948, available at: http://trade.wtosh.com/gatt_docs/English/SULPDF/90200202.pdf (accessed on 15 January 2009). The proposals were adopted without debate (see United Nations Conference on Trade and Employment, 'Sub-committee on Chapter VIII, Notes of the 17th Meeting', E/Conf.2/C.6/W.102, 16 February 1948, available at: http://trade.wtosh.com/gatt_docs/English/SULPDF/90200228.pdf (accessed on 15 January 2009).

'beyond compensation'.[29] In other words, if anything, the Havana Charter set rebalancing or compensation as the goal of suspensions, not sanction or punishment.[30]

Moving to the context of GATT, Article XXIII, it is interesting to note that Article XXIII was negotiated hand-in-hand with what are now Article XIX on safeguards and Article XXIII on tariff renegotiations. In both Article XIX and Article XXIII retaliation is also permitted in case no mutually acceptable compensation can be agreed. Yet, the reciprocal suspension in those articles must be 'substantially equivalent' to the concessions withdrawn as opposed to 'appropriate in the circumstances' under Article XXIII or 'equivalent' under DSU, Article 22.4. This 'substantially equivalent' standard seems to fall somewhere between the more flexible 'appropriateness' standard (in GATT, Article XXIII) and the stricter 'equivalence' standard (in the DSU).[31] Yet, in the one GATT case where suspensions under Article XXIII were authorized, the level of suspension was determined 'having regard to its *equivalence* to the impairment suffered by the Netherlands as a result of the United States restrictions'.[32]

[29] United Nations Conference on Trade and Employment, 'Reports of Committees and Principal Subcommittees for the International Trade Organization' (Geneva, 1948), 155, available at: www.wto.org/gatt_docs/English/SULPDF/90180096.pdf (accessed on 15 January 2009).

[30] What complicates matters, however, is that these Havana Charter clarifications occurred *after* the GATT itself was concluded and were subsequently not incorporated into the GATT. Article XXIII, GATT was, indeed, taken from the earlier Geneva draft of the failed ITO Charter. The legal value of those later Havana Charter clarifications is, therefore, questionable. On the one hand, one could say that they are an *ex post* confirmation of what the drafters of GATT also perceived as the goal of suspensions (compensation, not sanction). On the other hand, one could argue *a contrario* and focus on the fact that the Havana clarifications were *not* subsequently incorporated into the GATT so that the goal of GATT suspension was set at more than mere rebalancing and could include sanctions or punishment. According to John Jackson, one element which could explain this position is that the Havana Charter dealt with a broader range of obligations than GATT so that it made sense to offer softer remedies (compensation only) in the Havana Charter and harder remedies (sanction or even punishment) in the eventual GATT (see John Jackson, *World Trade and the Law of GATT*, 169).

[31] In support, see this 1988 statement by the GATT Legal Adviser where, after noting that suspension under Article XIX (safeguards) and Article XXVIII (tariff renegotiations) was limited to 'substantially equivalent' concessions, he added: 'In the case of Article XXIII, the wording was wider, referring to measures determined to be appropriate in the circumstances, which meant that there was a wider leeway in calculating the retaliatory measures under Article XXIII than under Articles XIX or XXVIII' (GATT doc. C/M/220, at 36, quoted in WTO, *Analytical Index: Guide to GATT Law and Practice* (Cambridge University Press, 1995), 698; and confirmed by the then Deputy Director-General (GATT doc. C/M/224, at 19), quoted in WTO, *Analytical Index: Guide to GATT Law and Practice*, 699.

[32] *Netherlands Action Under Article XXIII:2 to Suspend Obligations to the United States*, BISD 1S/62 (l/61), para. 2, see also para. 3 (italics added).

Thus, even when applying the 'appropriateness' standard in Article XXIII, an 'equivalence' standard along the lines of DSU, Article 22.4 was adopted. Rather than sanction or punishment, the goal of GATT suspension in the one and only GATT ruling on the issue seemed, therefore, to be rebalancing or compensation; not sanction or punishment. This philosophy was explicitly confirmed in the GATT-era Tokyo Code on Technical Barriers to Trade (1979), which provided for suspension in response to non-compliance 'in order to restore mutual economic advantage and balance of rights and obligations', thereby expressing the goal of rebalancing or compensation; not sanction or compliance.

As noted earlier, however, the biggest change from GATT to WTO in terms of suspension is no doubt that under GATT a consensus of all contracting parties was required to authorize retaliation. Hence, it was for the contracting parties *as a whole* to determine by consensus whether the retaliation is 'appropriate in the circumstances'. This meant that multilaterally approved retaliation (to be distinguished from unilateral sanctions, especially by the United States under section 301 of the Trade Act) only occurred once during the close to 50 years of GATT and, more importantly for our purposes, that any scope for harsh sanctions or punishment under Article XXIII remained purely illusionary: since the victim of the sanctions itself would have to agree to authorizing such sanctions, there was simply no way to impose punishment under GATT, Article XXIII. In the WTO, in contrast, the right to retaliation is automatic (under DSU, Article 22.6 only a consensus of all WTO members, including the complainant, can block retaliation). Yet, in return, the level of retaliation was made subject to multilateral control in the form of an arbitration that decides on whether proposed retaliation is 'equivalent' to nullification. In sum, with the WTO, retaliation became automatic both in the sense that there is no need for 'serious circumstances' (as Article XXIII provided for[33]) and no need for positive consensus to get it authorized. In return, however, the level of retaliation was limited to 'equivalence' and made subject to arbitration. Multilaterally controlled equivalence (requested, especially, by countries that had in the past been victims of unilateral US trade sanctions) was the *quid pro quo* for automatic sanctions (a demand formulated, especially, by the United States which had grown frustrated with the veto blocking of the old GATT dispute process).

[33] See note 25, above.

If the intended goal of GATT, Article XXIII suspension could be said to be focused on rebalancing or compensation (with an original idea or rather fictional option to move toward sanctions based on the flexible term 'appropriate'), the contextual message elucidating the goal of WTO suspension, in contrast, points toward sanction or rule compliance (albeit tempered by the 'equivalence' standard in DSU, Article 22.4). Indeed, whereas GATT, Article XXIII provided for 'appropriate' suspension only in 'serious circumstances', made subject to consensual approval of all GATT parties, and without follow-up or indication as to when such suspension would be ended (thereby implying that suspension could be a permanent rebalancing of concessions), the DSU repeatedly underlines that suspension does *not* end the matter (as in compensation that substitutes for rule compliance) but is rather a temporary instrument to achieve the ultimate goal of compliance or mutually agreed settlement. DSU, Article 22.1 stresses, for example, that 'compensation and suspension … are *temporary* measures' and that 'neither compensation nor … suspension … is preferred to full implementation'.[34] Crucially, by providing when suspension must be ended – that is, when the inconsistent measure is removed or when a mutually satisfactory solution is reached – DSU, Article 22.8 implicitly gives us the goal of WTO suspension: only if the illegality is removed or a settlement is found (not when, for example, the victim state is fully compensated) must suspension be removed. Hence, suspension is not a permanent rebalancing of concessions (as in tariff renegotiations under GATT, Article XXVIII), but a temporary solution that must be ended if, but only if, WTO rulings are implemented or a settlement is reached. The fact that the Dispute Settlement Body (DSB) must keep the matter under surveillance and that violating countries must submit regular status reports[35] underlines that suspension is temporary and not a substitute compensation for compliance.

In sum, the contextual goal of WTO suspension as expressed in the DSU is not rebalancing or compensation as such, but compliance or settlement. As further explained below, this goal is not only backed up by the formal 'equivalent retaliation' remedy, but also by informal remedies such as reputation and community costs linked to continued non-compliance. Indeed, it is the repeated expression in the DSU that the ultimate goal of the system is compliance that nurtured a general perception that compliance *is*, indeed, the goal. And it is precisely this general perception which,

[34] See also Articles 3.7 and 22.8, DSU

[35] See Articles 21.6 and 22.8, DSU.

in turn, is the trigger of, and necessary precondition for, the reputation and community costs linked to continued non-compliance (if, in contrast, the WTO community did not share the goal of compliance, breach combined with compensatory suspension could end the matter and would not create any further reputation or community costs; put differently, community costs do not depend on a sense of legal obligation *held by the violator*, but on the shared expectations of *other* WTO members). These informal costs must be added to the formal costs of equivalent retaliation and are, in combination, what explains, according to Davey (Chapter 7), the 83 per cent compliance rate with WTO dispute rulings,[36] notwithstanding the, at first sight, relatively weak remedy of equivalent suspension. In sum, to deduce from the formal remedy of equivalent retaliation alone that the goal of WTO suspension and dispute settlement more generally is mere rebalancing (or efficient breach) is too simple.

To summarize this brief historical overview, although the treaty texts could lead one to think otherwise ('appropriate' suspension in GATT versus 'equivalent' suspension in the WTO) and nothing was set in stone in either GATT or the DSU, the gradual evolution of what seems to be the commonly shared goal of trade suspension in the multilateral trade system is one from rebalancing/compensation in the GATT to compliance/settlement in the WTO.

To make an analogy with the default remedies in general international law, suspension under GATT, Article XXIII is best compared with treaty suspension in Article 60 of the Vienna Convention on the Law of Treaties where 'material breach' (similar to the 'serious circumstances' condition in GATT, Article XXIII) is a ground for 'suspending' treaty obligations. Like GATT, Article XXIII which refers only to 'appropriate' suspension, Article 60 of the Vienna Convention does not include an equivalence or proportionality standard. In addition, both Article XXIII and Article 60 are silent as to if and when suspension must be ended thereby implying that it could be a permanent state of affairs that settles the matter.

Suspension in the WTO, in contrast, is best compared with countermeasures in Article 49 of the International Law Commission's Articles on State Responsibility. There, any continuation of an 'internationally wrongful act' (as with WTO suspension, there is no need for 'material breach' or 'serious circumstances') gives rise to a right to take 'countermeasures'. Yet, such countermeasures are subject to a proportionality standard, comparable with (but somewhat more flexible than) the equivalence standard

[36] See, William Davey, 'Sanctions in the WTO: Problems and Solutions', section 1.

in the DSU.[37] Similarly to DSU, Article 22.8 stating that 'suspension … shall only be applied until such time as the [inconsistent] measure … has been removed', Article 49.2 explains that countermeasures 'are limited to the non-performance for the time being of international obligations'.[38] In addition, the goal of countermeasures is explicitly stated 'to induce [the violating State] to comply with its obligations'.

That the evolution from GATT to WTO suspension has been one from 'treaty suspension' under the Vienna Convention to 'countermeasures' under the Articles of State Responsibility is confirmed in the gradual change of terminology commonly used to refer to GATT/WTO 'suspension'. Whereas in the GATT days, and even in the early days of the WTO, countries insisted on reference to 'suspension' (and chided the language of sanctions, retaliation or countermeasures), today, it is commonly accepted to use what Steve Charnovitz calls the 'S-word' and even more common to refer to WTO 'retaliation' or 'countermeasures'. WTO arbitrators on suspension when seeking guidance from general international law have also referred to countermeasures in the Articles on State Responsibility, not suspension under the Vienna Convention. Hence, although we are stuck with the old GATT/Vienna Convention term of 'suspension' even in the DSU (but not in the Subsidies and Countervailing Measures (SCM) Agreement which does use the term 'countermeasures', as discussed below), for all intents and purposes, what we now have in the WTO is something more akin to retaliation or countermeasures as they are expressed in the Articles on State Responsibility.

6 Statements in WTO arbitration reports as to the goal(s) of WTO suspension

Another avenue to pursue in order to figure out the intended goal of WTO suspension is to check what WTO arbitrators themselves have said about the issue. As with the historical evolution sketched above, statements in WTO arbitration reports on suspension have often been less than clear

[37] See Article 51, ILC Articles on the Responsibility of States for Internationally Wrongful Acts (ILC Articles), Annex to A/RES/56/83 of 12 December 2001, as corrected by UN doc. A/56/49 (vol. I), Corr. 4, which provides that '[c]ountermeasures must be commensurate with the injury suffered, taking into account the gravity of the internationally wrongful act and the rights in question'.

[38] See also Article 53, ILC Articles: 'Countermeasures shall be terminated as soon as the responsible State has complied with its obligations under Part Two in relation to the internationally wrongful act'.

and made reference to multiple goals. Moreover, as with the evolution from GATT (rebalancing or compensation) to WTO (compliance or settlement), there has been an evolution in WTO case law on the stated goal of WTO suspension. This time, three phases or trends can be detected:

(i) unequivocal statements that 'inducing compliance' is *the* goal of WTO suspension (*EC–Bananas (US)*, *EC–Hormones*, *EC–Bananas (Ecuador)* and *US–Gambling*);
(ii) rulings where close to (and, in one case, genuine) punitive suspension was authorized in response to prohibited subsidies ('appropriate countermeasures' in *Brazil–Aircraft*, *US–FSC*, *Canada–Export Credits and Guarantees*); and
(iii) a sense of crisis or disillusion in regular cases (other than prohibited subsidy cases) with statements that the goal of WTO suspension in the DSU is not clear and might, given its 'equivalence' benchmark, not be compliance (*US–1916 Act*, *US–Byrd*).

Phase 1: induce compliance (albeit with equivalent suspension)

Phase I could be referred to as 'the lion roars but realizes it has no teeth'. The following statement in the very first WTO arbitration on suspension (*EC–Bananas (US)*) – is emblematic:

> the authorization to suspend concessions or other obligations is a temporary measure pending full implementation by the Member concerned. We agree with the United States that this *temporary* nature indicates that it is the purpose of countermeasures to *induce compliance*.[39]

Yet, in the same breath, the roaring lion (announcing that suspension is there to achieve the rather ambitious goal of 'inducing compliance'), faces reality and must add the following:

> But this purpose does not mean that the DSB should grant authorization to suspend concessions beyond what is *equivalent* to the level of nullification or impairment. In our view, there is nothing in [the DSU] that could be read as a justification for counter-measures of a *punitive* nature.[40]

Therefore, from the very beginning the tension between, on the one hand, the *more ambitious goal* of compliance (newly expressed in the DSU) and,

[39] *EC–Bananas (US)*, Decision by the arbitrators under Article 22.6, DSU, WT/DS27/ARB (DSR 1999:II, 725), para. 6.3 (italics in original, underlining added).
[40] *EC–Bananas (US)*, *ibid*.

on the other hand, the *weakened instrument* of equivalent (rather than appropriate) suspension to achieve that goal, was acknowledged.[41]

The goal of 'inducing compliance' was subsequently also confirmed in *EC–Bananas (Ecuador)*, where the arbitrators decided that retaliation by Ecuador against the EC under GATT was not 'effective' to induce compliance and, on that ground, granted Ecuador the right to cross-retaliate under TRIPS (pursuant to DSU, Article 22.3):

> Our interpretation of the 'practicability' and 'effectiveness' criteria is consistent with the object and purpose of Article 22 which is to induce compliance. If a complaining party seeking the DSB's authorization to suspend certain concessions or certain other obligations were required to select the concessions or other obligations to be suspended in sectors or under agreements where such suspension would be either not available in practice or would not be powerful in effect, the objective of inducing compliance could not be accomplished and the enforcement mechanism of the WTO dispute settlement system could not function properly.[42]

Phase 2: inducing compliance requires more than equivalent suspension ('appropriate countermeasures' in response to prohibited subsidies)

As further explained by Sebastian (Chapter 4), WTO suspension in response to prohibited subsidies under the SCM Agreement is not bound by the 'equivalence' standard in DSU, Article 22.4, but by what seems to be a more flexible standard of 'appropriate countermeasures' (SCM, Article 4.10). This, of course, reminds us of the 'appropriateness' standard under GATT, Article XXIII. Note, also, that in this case, the old term 'suspension' (reminiscent of treaty suspension under the Vienna Convention) was dropped in favour of the term 'countermeasures' (as in the Articles on State Responsibility). This confirms the above argument that from GATT to WTO we have witnessed a gradual shift from suspension as 'treaty suspension' under the Vienna Convention, to 'countermeasures' under the Articles on States Responsibility.

[41] See also *EC–Hormones*, Decision by the arbitrators under Article 22.6, (DSR 1999:III, 1135), para. 39: 'The DSU characterizes full and prompt implementation of DSB recommendations as the *first* objective and *preferred* solution. The suspension of concessions, in contrast, is only a temporary measure of last resort to be applied only until such time as full implementation or a mutually agreed solution is obtained. To allow the effect of suspension of concessions to exceed that of bringing the measure into conformity with WTO rules would not be justifiable in view of DSU objectives' (italics in original).

[42] *EC–Bananas (Ecuador)*, Decision by the arbitrators under Article 22.6, DSU, WT/DS27/ABR/ECU, para. 76 (underlining added).

Recall, however, that unlike the 'appropriateness' standard in GATT, Article XXIII, the 'appropriateness' standard under SCM, Article 4.10 is not subject to consensual approval by all GATT/WTO members. Whereas under GATT 'appropriateness' was kept within strict bounds because of the consensus requirement (and in the one GATT case on the issue reduced to 'equivalence'[43]), in the SCM Agreement, the decision on 'appropriateness' was transferred to third-party arbitration. This prompted the drafters of the SCM Agreement to add the cautionary footnote 10 to the Agreement, stating that the expression 'appropriate' is 'not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited'. Ironically, however, arbitrators tasked to interpret what seems to be a softening footnote have used it rather to bolster their conclusion that retaliation in response to prohibited subsidies calls for something *more than* 'equivalent' suspension.

The arbitrators in *Brazil–Aircraft*, for example, the first dispute under SCM, Article 4.10, started by confirming that the goal of WTO suspension is to induce compliance: 'We conclude that a countermeasure is 'appropriate' *inter alia* if it *effectively* induces compliance.'[44] It then went on, however, to find that this objective requires more than 'equivalent' suspension, referring, *inter alia*, to footnote 10:

> [R]equiring that countermeasures in the form of suspension of concessions or other obligations be equivalent to the level of nullification or impairment would be contrary to the principle of effectiveness by significantly limiting the efficacy of countermeasures in the case of prohibited subsidies.[45]

On this and other grounds, the arbitrators saw no problem in selecting the *entire amount of the subsidy* as the benchmark for calculating

[43] See note 32, above.

[44] *Brazil–Aircraft*, Decision by the arbitrators under Article 22.6, DSU and Article 4.11, SCM Agreement, WT/DS46/ARB (DSR 2002:I, 19), para. 3.44. The objective of 'inducing compliance' was subsequently confirmed in all prohibited subsidy cases. See, for example, *US–FSC*, Decision by the arbitrators under Article 22.6, DSU and Article 4.11, SCM Agreement, WT/DS108/ARB (DSR 2002:VI, 2517), para. 5.52 ('countermeasures are taken against non-compliance, and thus its authorization by the DSB is aimed at inducing or securing compliance with the DSB's recommendation'), and *Canada–Export Credits and Guarantees*, Decision by the arbitrators under Article 22.6, DSU and Article 4.11, SCM Agreement, WT/DS222/ARB, para. 3.48 ('We agree that the need to induce compliance is a factor that should be considered in evaluating the appropriateness of the level of proposed countermeasures.').

[45] *Brazil–Aircraft*, para. 3.58.

'appropriate countermeasures' in response to prohibited subsidies, even if this benchmark could go beyond the 'equivalent' trade effects caused by the original violation. As the arbitrators in *US–FSC* put it, with reference to Article 51 of the Articles on State Responsibility quoted earlier:[46]

> [A] Member is entitled to act with countermeasures that properly take into account the gravity of the breach and the nature of the upset in the balance of rights and obligations in question. This cannot be reduced to a requirement that constrains countermeasures to trade effects.[47]

At the same time, the Arbitrators did add that: '[t]here is nothing in the text or in its context which suggests an entitlement to manifestly punitive measures'.[48] The tough approach in prohibited subsidy cases (defining 'appropriate countermeasures' as something going beyond equivalence but not 'manifestly punitive') culminated in the *Canada–Export Credits and Guarantees* dispute. In that case, the arbitrators not only opted for the entire amount of the subsidy as the benchmark for 'appropriateness' but, in addition, increased this amount by 20 per cent on the ground that Canada had provoked the arbitrators by saying that it would not comply with the entire ruling:

> we are of the view that Canada's statement that, for the moment, it does not intend to withdraw the subsidy at issue suggests that in order to induce compliance in this case a higher level of countermeasures … would be necessary and appropriate.[49]

> … we have decided to adjust the level of countermeasures … by an amount which we deem reasonably meaningful to cause Canada to reconsider its current position … We consequently adjust the level of countermeasures by an amount corresponding to 20 per cent of the amount of the subsidy.[50]

This no doubt means that, at least in response to prohibited subsidies, punitive suspension, beyond equivalence, is a possibility. In other words, whereas in ordinary DSU cases, arbitrators felt reigned in by the equivalence standard when attempting to give effect to what they perceived to be the goal of 'inducing compliance', arbitrators in SCM cases, in contrast, jumped on the flexibility in the appropriateness standard to boost the amount of WTO suspension in the hope of more effectively achieving

[46] See note 37, above. [47] *US–FSC*, para. 5.55. [48] *US–FSC*, para. 5.56.
[49] *Canada–Export Credits and Guarantees*, para. 3.107.
[50] *Canada–Export Credits and Guarantees*, para. 3.121.

the stated goal of compliance. Put differently, whereas in Phase 1 the lion roared but realized it lacked teeth, in Phase 2, the lion roared, found its teeth and eagerly attacked.

Phase 3: identity crisis and doubt as to the goal of WTO suspension in regular DSU cases

After the euphoria of arbitrators authorizing what is effectively punitive suspension in prohibited subsidy cases, arbitrators in ordinary DSU disputes quickly faced reality, as expressed in the equivalence standard, and started to question the very goal of WTO suspension. Indeed, if earlier arbitrators said that inducing compliance cannot be achieved effectively with equivalent suspension (see *Brazil–Aircraft* quoted above), are we sure that under the DSU, where there is the ceiling of equivalent suspension, the goal really is compliance (as early arbitrators quoted under Phase 1 so categorically claimed)? In *US–1916 Act*, the arbitrators clung to 'inducing compliance' as *a key* objective of WTO suspension, but acknowledged that WTO suspension may also have other goals:

> The European Communities stressed that 'the basic purpose of the suspension of concessions or other obligations is to induce compliance of the other Member with its WTO obligations'. The United States suggested other possible purposes, such as 'to restore the balance of benefits under the covered agreements between the parties to the dispute'.[51]
>
> … in our view, a key objective of the suspension of concessions or obligations – whatever other purposes may exist – is to seek to induce compliance by the other WTO Member with its WTO obligations.[52]

The move away from putting up 'inducing compliance' as the goal of WTO suspension culminated in *US–Byrd*, where the arbitrators turned the statements made during Phase I on their head, concluding essentially that they are far from certain that inducing compliance is even one of several goals of WTO suspension:

> The concept of 'inducing compliance' … is not expressly referred to in any part of the DSU and we are not persuaded that the object and purpose of the DSU – or of the WTO Agreement – would support an approach where the purpose of suspension … would be exclusively to induce compliance. [We] cannot exclude that inducing compliance is part of the objectives

[51] *US–1916 Act*, Decision by the arbitrators under Article 22.6, DSU, WT/DS136/ARB (DSR 2004:IX, 4269), para. 5.3.

[52] *US–1916 Act*, para. 5.5. See also para. 5.7: 'We agree that a fundamental objective of the suspension of obligations is to induce compliance'.