The Institutional Design of Trade Policy Flexibility in the World Trading Order Analysis and New Direction for Reform

DISSERTATION
der Universität St. Gallen,
Hochschule für Wirtschafts-,
Rechts- und Sozialwissenschaften (HSG)
zur Erlangung der Würde eines
Doktors der Wirtschaftswissenschaften

vorgelegt von

Alexander Roitinger
aus
Liechtenstein

Genehmigt auf Antrag der Herren

Prof. Dr. Heinz Hauser
und
Prof. Dr. Jean-Max Baumer

Dissertation Nr. 2915

Difo-Druck GmbH, Bamberg 2004

Die Universität St. Gallen, Hochschule für Wirtschafts-, Rechts- und Sozialwissenschaften (HSG), gestattet hiermit die Drucklegung der vorliegenden Dissertation, ohne damit zu den darin ausgesprochenen Anschauungen Stellung zu nehmen.

St. Gallen, den 4. Mai 2004

Der Rektor:

Prof. Dr. Peter Gomez

To my parents
Elfi and Gerhard Roitinger

Acknowledgements

There are many people to whom I am much indebted for their continuous support.

It was Professor Heinz Hauser who inspired me to focus on institutional issues of the world trading order, which turned out to be an extremely rewarding topic. I benefited considerably from his ability to detect promising new trends in research. Furthermore, he provided me with an excellent working environment at the *Swiss Institute for International Economics and Applied Economic Research*.

Professor Jean-Max Baumer has been a great personal mentor for many years. I have always admired his broad academic curiosity. It is no exaggeration to say that he played a pivotal role at the time when I started to consider engaging in a doctoral program.

Thomas Liebig and Thomas Zimmermann not only read an early version of the completed study, but have also helped me with their invaluable advice from the very beginning of the doctoral program. Thorsten Götz, Ingo Borchert, and Tobias Beljean gave useful comments on individual chapters, while Pamela Gasser-Johnson checked the correct use of the English language.

Most of all, I am grateful for the incessant support from my parents. Their encouragement, their loving care, and their unquestioning confidence in me made it possible to complete this study without any major setbacks.

Zurich, May 2004 Alexander Roitinger

Contents

How can the corsets of international agreements be made more flexible and therefore more robust?

Barbara Koremenos

1 Introduction

1.1 Motivation for the study

Until recently, research on the institutional design of the world trading order was dominated by legal scholars. International economists restricted themselves to the emphasis of the advantages of liberalised trade and to reflecting on why governments are so reluctant to follow their advice. With the successful launch of the World Trade Organisation (WTO), however, economists realised that they have more to contribute than David Ricardo or Mancur Olson.[1] In the last few years, an extensive body of economic literature has emerged, which analyses and explains many of the rules that today govern the exchange of goods across countries.

This study is intended to add to this literature by exploring the multilateral institutional design of trade policy flexibility. Trade policy flexibility is understood as the ability of governments to decide unilaterally when to introduce new temporary import restrictions *after* an international trade agreement has been concluded. Such restrictions impede the free flow of goods and therefore reduce social welfare. However, there is a strong presumption that governments would not be willing to initially conclude agreements if the latter made it impossible to raise import barriers *under exceptional circumstances*. Therefore, the question of the optimal design of trade policy flexibility arises.

[1] The former introduced, according to Paul Samuelson, the only law of economics that is both true and non-trivial: the law of comparative advantage. The latter showed how the influence of special interest groups on the political process can impair social welfare.

The ability to introduce temporary import restrictions is supported to a certain extent by a number of devices set out in the agreements of the WTO.[2] I will call them flexibility instruments. The most prominent one is probably the Safeguard Clause in Article XIX of the General Agreement on Tariffs and Trade (GATT). Provided that some prerequisites are fulfilled, imports can be barred for a certain period of time. The prerequisites define the economic circumstances that have to prevail before a restriction is introduced. The more prerequisites there are, the more limited is the ability of governments to make a protectionist decision. Hence, the prerequisites for temporary import restrictions impair trade policy flexibility.

One might be tempted to argue that trade policy flexibility is the natural antagonist of a rule-oriented trading regime. However, this perception would be wrong. Flexibility, as understood here, does not leave everything "up for grabs". Allowing governments to decide when to introduce temporary import restrictions is perfectly reconcilable with a set of established rules, as long as these rules do not undermine the possibility of effectively protecting import-competing industries. For example, trade policy flexibility can be subordinated to Most-Favoured-Nation (MFN) treatment in accordance with Article I GATT: the level of imports can be reduced *without* discriminating among foreign exporters. Furthermore, trade policy flexibility need not conflict with the elimination of quantitative restrictions (as requested by Article XI GATT) or the abolishment of other non-tariff barriers: it is possible to effectively restrict imports by tariff measures. Most importantly, however, trade policy flexibility can be linked to mandatory compensation for trading partners.

What is understood by the introduction of *temporary* import restrictions? In the past, some import restrictions that had been claimed to be of a temporary nature were subsequently criticised for being unduly extended and becoming a long-term barrier to trade. Despite such incidents that blur the borderline, most import restrictions introduced after the conclusion of a respective agreement have been terminated *within a few years*: such measures have at large not been used for a permanent change of multilateral market access concessions. Indeed, there are good reasons why new import restrictions are of a

[2] Most WTO agreements are the result of the Uruguay Round negotiations concluded at the Marrakesh Ministerial Meeting in April 1994. There are about 60 different agreements and decisions.

temporary nature: trade barriers are porous.[3] Foreign exporters adjust their behaviour (nature of products, location of production etc.) in order to evade them. Therefore, permanent import restrictions are often ineffective.

The aim of this study is to evaluate the multilateral rules on trade policy flexibility. Whenever this flexibility is high, there are few or no prerequisites for the temporary increase of import restrictions. A world without international trade agreements would right from the start ensure a high level of trade policy flexibility. However, a high flexibility level does not necessarily depend on the absence of such agreements. Far from it, international trade agreements may be interpreted as institutions that codify the use of trade policy flexibility. In this case, these agreements would not primarily formulate the road to liberalisation, but determine the conditions of temporary deviation from liberalisation.

The study is not limited to a mere description of institutional aspects with regard to temporary protection. Rather, the descriptive work is complemented by an extensive analysis of suggestions for institutional reform: how could the current number of temporary import restrictions be reduced while ensuring that governments do not lose their interest in present and future international trade agreements? The analysis is motivated by the observation that many proposals have been made in the past, but that almost all of them are one-sided in an important respect: their exclusive aim is to curb trade policy flexibility. They *risk* leading to an impasse if one takes a specific perspective on government behaviour in international trade negotiations. This perspective can be summarised by the claim that governments are not willing to give up trade policy flexibility on a multilateral level. While I do not formally prove that this view is correct, there are both theoretical considerations and empirical facts that emphasise the plausibility of my assumption.

Provided that the assumption has some merits, however, there are fundamental implications for an appropriate reform of individual flexibility instruments: the best solution would not consist in raising the prerequisites for temporary import restrictions, but in laying down compensation as an inherent element of trade policy flexibility. Whenever I talk about compensation and do not state otherwise, I have in mind trade

[3] This is confirmed e.g. by Ethier (1998).

compensation, i.e. trade-liberalising measures in sectors unrelated to the temporary protection.

1.2 Executive summary

The following chapter clarifies some conceptual aspects of trade policy flexibility. Since the preoccupation with flexibility primarily makes sense in the presence of international co-operation, the rationale behind trade agreements is examined. Subsequently, the WTO agreements are scanned in order to identify all flexibility instruments that are currently available. Surprisingly, only four devices provide true trade policy flexibility: Safeguard Clause measures (or: safeguard measures), antidumping, countervailing duties, and the violation of WTO agreements. The last instrument is an expression of the fact that governments sometimes apply measures that are not in accordance with explicit WTO rules.

In Section 2.3 of the following chapter, the definition of trade policy flexibility for the purpose of this study is set in the context of other flexibility concepts used in the literature. Since trade policy flexibility emphasises a strong role of governments and possibly depends on the intergovernmental character of the WTO, Section 2.4 examines its interface with a potential introduction of private rights into the multilateral trading order.

An empirical assessment of the four flexibility instruments is made in Chapter 3. The Safeguard Clause has had an ever-changing history since 1948, with numerous upturns, downturns and a recent strong increase, caused by the United States (US) action on steel and a rising safeguard activity among developing countries. Antidumping activity has been intense for the last twenty years. Even since the end of the Uruguay Round, which was praised for the attempt to curb its use, it has not been restrained. More and more countries are actively engaged in respective policies. While the developing world has become a regular user in the last few years only, it has always been the primary target of developed country antidumping policy. As regards countervailing duty measures, they have not become more frequent after the conclusion of the Uruguay Round. Corresponding to this observation is the fact that there is no rising trend in the number of countries applying the instrument. Developed countries dominate, and the developing country share is on the decline.

In contrast to the use of lawful flexibility instruments, violations of WTO agreements are not immediately notified to the WTO Secretariat. Problems with incomplete data are therefore particularly pronounced. Useful information is only available for the period since 1995, which is not long enough to recognise a trend over time. There seems to be a considerable congruence between defendants and complainants: all major defendants are also major complainants (and *vice versa*). While developing countries are less actively engaged in the dispute settlement procedure, there are some indications that the new Dispute Settlement Understanding (DSU) is not biased against them.

An interesting result of Chapter 3 are the so-called complaint ratios. A complaint ratio is the division of respective complaints under the DSU by the total number of notified measures under safeguard, antidumping, or countervailing duty rules. The higher the ratio, the higher is the share of notified measures that should actually not be categorised as safeguard, antidumping, or countervailing duty action, but rather as violations of WTO agreements.[4] The complaint ratios show that antidumping measures mostly correspond to the rules, whereas safeguard measures are regularly not in consistency with them. It follows that many temporary import restrictions that are formally notified as safeguard measures represent in fact no action under Article XIX GATT, but violations of WTO agreements.

Chapter 4 provides the theoretical foundation for trade policy flexibility. It conceives trade policy as a unitary mechanism to achieve certain distributive ends and offers a stepwise introduction to the political economy of international trade. In a first step, a number of models describe the equilibrium structure of trade protection in a small country. Their main message is that governments respond to organised interests when formulating trade policy decisions. The seminal contribution of Grossman and Helpman (1994) will figure prominently in this analysis.

In a second step, strategic interaction is introduced. Governments behave either unilaterally (ignoring the impacts of their behaviour on foreign counterparts) or co-operatively. In the latter case, they conclude an international trade agreement. It is possible to show what such an agreement looks like in the presence of organised interest groups. The equilibrium trade intervention for an industry is influenced by the relative

strength of the lobbies at home and abroad: the lobby that has the greater stake in the negotiation will get more deviation from free trade than the corresponding foreign lobby.

In a third step, Chapter 4 goes beyond a description of the static protection structure scheduled in an international trade agreement: governments are now able to endow the agreement with mechanisms that maintain their trade policy flexibility. The characteristics of such an agreement are investigated by adjusting a model of Ethier (2002). The agreement determines a commensurate price for the use of trade policy flexibility: the consequence of a domestic temporary import restriction is a foreign response that restores the reciprocity of tariff reduction. While Ethier only considers a suspension of concessions for this purpose, the result of a commensurate price is equally important for the case of compensation in the form of trade-liberalising measures.

Chapter 5 of this study defines 13 criteria that are useful for an extensive analysis of current flexibility instruments. The criteria are categorised into five groups:

(1) Preliminary stage: What has to be observed before an instrument is used? (Example: what are its prerequisites?)

(2) Form of protection: How are imports restricted?

(3) Balancing: What happens to trading partners who are negatively affected? (Example: do they receive compensation?)

(4) Control: Is the use of an instrument monitored?

(5) Developing countries: Is there something special with them?

This categorisation allows the evaluation of the safeguard, antidumping, and countervailing duty instruments. As regards the violation of WTO agreements, it is still useful, even though its explanatory power is reduced. The analysis of the four flexibility instruments is based on the relevant text of the WTO agreements and the respective adjudication. In addition, existing suggestions for their reform are portrayed. While Chapter 5 is comprehensive in its description, it is not comparative: it examines each instrument separately.

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[4] The number of violations can be approximated by the number of complaints since the overwhelming majority of disputes (which reach the adjudication stage) are decided in favour of the complainant.

A comparative analysis stands, however, at the beginning of Chapter 6. A common denominator of the existing suggestions for reform is defined by using two of the criteria introduced in Chapter 5: prerequisites and compensation. Today, antidumping, countervailing measures and the violation of WTO agreements have no compensation component, whereas the Safeguard Clause has a medium compensation level. As regards prerequisites, these are non-existent for violations, low for antidumping, medium for countervailing measures and high for the Safeguard Clause.

Existing suggestions for reforming the institutional design of flexibility seem to indicate that the optimal lawful instrument for temporary import restrictions has a high level of prerequisites, while compensation should not be owed. As regards violations, the path towards higher prerequisites is barred. Therefore, according to existing suggestions, compensation ought to play a more prominent role here. Apparently, compensation is regarded as some kind of last resort, useful only to the extent that a rise of prerequisites is technically not feasible. However, high prerequisites for temporary import restrictions impair the government's trade policy flexibility. Chapter 6 provides a simple theoretical framework and some historical experience with trade remedy reform in order to show that the prerequisites path runs the risk of either bringing about a standstill in future multilateral negotiations or provoking an increase in violations.

In order to overcome this problem, I propose an alternative approach for reform. It consists of shifting the focus from prerequisites to compensation. A new regime might maintain the trade policy flexibility inherent in current antidumping and countervailing duty rules by requiring no prerequisites for temporary import restrictions. However, any restriction would have to be combined with full compensation for any trading partners affected. Full compensation would ensure that no government introduces temporary import restrictions under what I will call normal political circumstances. Simultaneously, the compensation requirement does not impair trade policy flexibility at times of political stress.

This alternative solution should lead to an overall reduction of temporary import restrictions. It could be implemented by means of three modifications to the WTO agreements. Firstly, both antidumping and countervailing duty measures would have to be banned. It has been thoroughly documented in the past that they have lost any connection with "unfair trade", whatever the precise meaning of unfair may be. Instead, they have

become ordinary instruments for the protection of organised interests, eluding compensation for those who are negatively affected. Secondly, the Safeguard Clause would have to be modified by removing its prerequisites[5] and eliminating the current exception to the full compensation requirement. This would preserve trade policy flexibility and at the same time prevent governments from introducing temporary import restrictions under normal political circumstances. Thirdly, the DSU would have to stipulate that compensation is both mandatory and retroactively owed as of the date when a violation is brought to the attention of the WTO. This ensures that the reform of lawful flexibility instruments is not swept off by an evasion manoeuvre towards the violation instrument.

While I admit that there is a significant discrepancy between today's regime and my suggestion for a new design (being politically difficult to overcome), this does not invalidate the conclusion that any steps for institutional reform have to go in the right direction. Otherwise, progress is not sustainable.

[5] Remember that the prerequisites define the economic circumstances that have to prevail when an import restriction is introduced.

2 The Concept of Trade Policy Flexibility

2.1 The rationale behind international trade agreements

Governments conclude international trade agreements in order to reap some sort of benefits from transnational co-operation. While this basic statement has intuitive appeal, it is not so clear-cut on second inspection. This can be shown by asking a simple question: What are these benefits of an international trade agreement?

The traditional economic answer to this question is well-known. Governments seek to maximise national social welfare. From the perspective of an individual government, this requires the setting of positive ("optimal") tariff rates whenever a tariff is able to reduce the export price of foreign suppliers (i.e. whenever the foreign export supply is not perfectly elastic). The price reduction improves the domestic terms of trade, and this enhances welfare. However, if all governments behaved like this, the resulting *Nash* equilibrium in tariff rates would not be efficient any more: social welfare could be increased worldwide if tariffs were abolished. Consequently, the benefit of an international trade agreement is to eliminate negative terms-of-trade externalities.[6] This allows trade volumes to increase.

Chart 2.1 shows that the global exchange of goods has indeed increased significantly since the entry into force of the GATT on 1 January 1948. Between 1948 and 2002, there was a growth by 580 percent for agricultural products and by 4'140 percent for manufactures. This corresponds to average annual growth rates of 3.3 and 7.1 percent, respectively, which clearly exceeds the growth in output. According to the traditional economic approach, a considerable part of this growth would have come from a GATT-induced reduction of terms-of-trade externalities.

[6] There is a substantial amount of literature formulating this answer, the most prominent source being Johnson (1953).

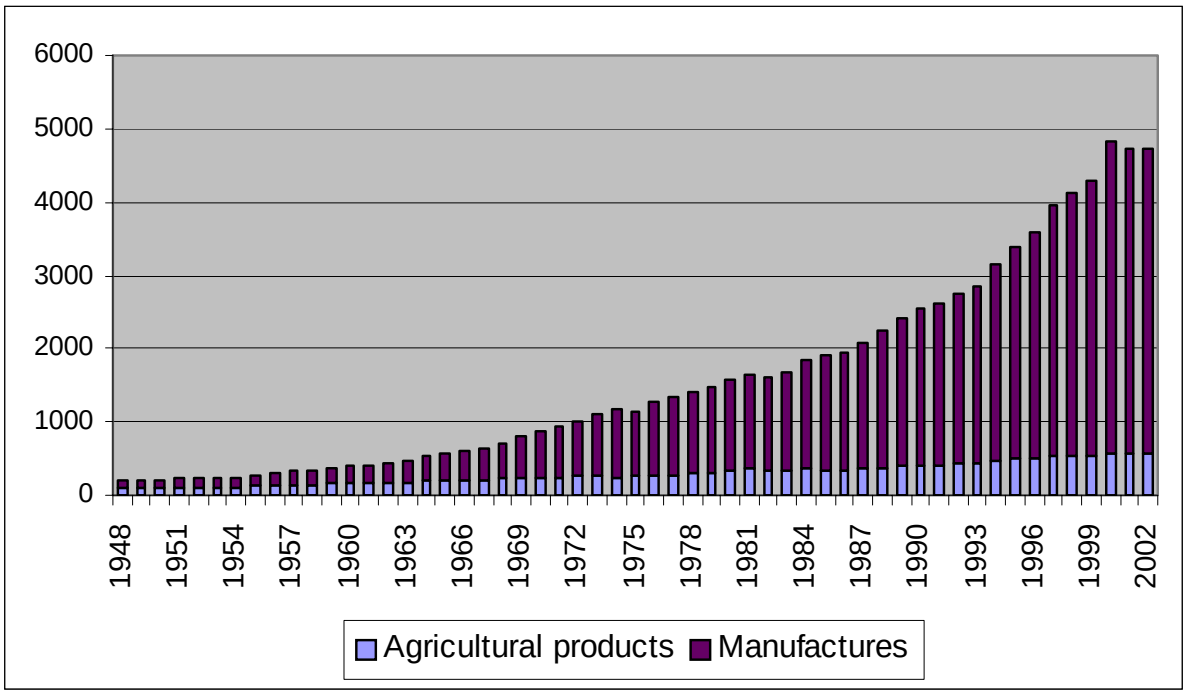

Chart 2.1: Volume indices for world trade 1948-2002 (1948=100)[7]

However, there are at least three problems with the asserted relevance of the terms of trade. Firstly, there are small countries (defined in respect of their demand share on world markets) which have high tariffs, although they are not able to affect foreign export prices.[8] On the other hand, there have always been large countries deciding unilaterally not to set welfare-maximising ("optimal") tariffs. However, if tariffs were regularly not related to terms-of-trade considerations, how should the latter explain the reduction of the former by means of an international trade agreement?

The second problem is even more puzzling: if international trade agreements really cared about the elimination of terms-of-trade externalities, they would be expected to prevent countries from implementing export taxes. However, the GATT has no single provision that prohibits governments from raising the price of domestic exports.[9] While one could argue that the GATT is silent on this issue because no government wants to tax domestic exports anyway, this again raises doubts as to the significance of the terms of trade in trade policy considerations.

[7] Data source: WTO website.
[8] Many developing countries could be cited as an example.
[9] See Ethier (2003, 2002a).

The third problem is nurtured by recent findings of Rose (2002). He shows by the use of a standard gravity model of bilateral trade[10] that membership in the WTO (or in the GATT, respectively) has not been associated with enhanced trade once other explanatory factors are taken into account. This empirical fact suggests that even if the terms of trade were relevant, a formal agreement such as the WTO (or the GATT) may not be necessary to eliminate their negative externalities.

Another way of answering the question about the benefits of an international trade agreement is provided by the so-called commitment approach. Again, the government is assumed to be benevolent. However, it is in need of a device that enhances its trade policy credibility in the face of domestic interest groups.[11] Matsuyama (1990) presents a three-stage model in which the government can maintain or terminate protection of an industry. In the first stage, the government announces its intention. The industry decides on investments for restructuring in the second stage. As a last step, the government implements its trade policy. The credibility problem is the following: while the government might wish to terminate protection and announce its intention in stage one, the industry could refuse to respond with the required restructuring, hoping that the government changes its mind once it realises that the industry is unprepared for liberalisation. In this case, the industry could be compelled to launch the restructuring process only if the government were unable to deviate from its first-stage announcement. This could be achieved by an international trade agreement that envisages liberalisation in stage three and punishes non-compliance. As a consequence, the government could credibly announce its liberal trade policy, i.e. the industry would not doubt the government's determinedness.

Do governments indeed conclude international trade agreements in order to bind their hands on trade policy issues in the face of domestic interest groups? The answer to this question does not only give guidance on the benefits of an agreement, but it also has fundamental implications for the appraisal of trade policy flexibility: if the commitment approach to international trade agreements were the only valid one, trade policy flexibility would be against the intrinsic interest of governments. However, this would not

[10] Such models explain trade with the distance between countries and their joint income. Rose augments the basic gravity equation with a number of additional conditioning variables that have a presumable effect on trade, e.g. culture and history.

necessarily imply that they negotiate agreements containing no flexibility instrument. Although a successful binding of hands would make a government resistant to interest group pressure *ex post*, this pressure might be all the more strong in the run-up to the conclusion of an agreement, forcing governments to maintain trade policy flexibility.

In fact, the negotiated extent of flexibility need not crucially differ between the scenario in which governments do not want to have their hands bound in the face of domestic interest groups and the alternative scenario in which they would like to be bound *ex post*, but are impeded from concluding a respective agreement due to *ex-ante* interest group pressure. Empirical findings on the extent of trade policy flexibility are therefore unable to determine the explanatory power of the commitment approach. However, in one respect the empirics are able to say something about the approach: if governments really intended to bind their hands, they would still have a long way to go. The data in Chapter 3 on the actual use of flexibility instruments – in particular the numbers on the violation instrument[12] – impressively show that there should still be a huge credibility problem in the spirit of Matsuyama.

The commitment approach does not play an important role in this study. Firstly, despite some advances, the approach has not yet figured prominently in the economic interpretation and evaluation of the multilateral trading system.[13] Therefore, the models in Chapter 4 on the political economy of trade policy ignore it. Secondly, the descriptive analysis of flexibility instruments in Chapter 5 is not dependent on a particular approach to international trade agreements. Thirdly, as regards the evaluation of existing suggestions for flexibility reform and my alternative solution in Chapter 6, the main hypothesis is that governments are not willing to give up trade policy flexibility by means of multilateral trade agreements. While this is a strong assumption, it is again not

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[11] Such credibility problems are discussed, among others, by Staiger and Tabellini (1999, 1989, 1987), Maggi and Rodríguez-Clare (1998), Tornell (1991), Maskin and Newberry (1990), and Lapan (1988).

[12] The numerous violations of WTO agreements are, at first glance, in clear opposition to the commitment approach. If governments intended to bind their hands by an agreement, they would not want to violate it after its conclusion. However, the fact that governments potentially *intend* to bind their hands does not exclude the possibility that they are unable to realise this intention. The obligation of an agreement may simply not be strong enough in order to enable governments *ex post* to resist the pressure of interest groups.

[13] This opinion is confirmed by Bagwell and Staiger (2002), p. 36. Nonetheless, the importance of the commitment approach has been recognised for a long time, notably from a constitutionalist perspective, see e.g. Hilf and Petersmann (1993), Petersmann (1991), Hauser (1988, 1988a, 1986) or Tumlir (1983).

sensitive on the acceptance or rejection of the commitment approach: the missing readiness of governments to give up flexibility could stem as well from an intrinsic desire (invalidating the commitment approach)[14] as from the pressure of interest groups in the run-up to the conclusion of an international trade agreement (which would still be conformable with the commitment approach).

The third possible answer to the question about the benefits of an international trade agreement directly arises from the political-economy literature. It has been argued above that under the commitment approach, governments might fail to bind their hands because of interest group pressure. In other words, interest groups set a constraint to the social welfare maximisation of the government. Under the political-economy approach, in contrast, interest group activity is not a constraint to utility maximisation, but it is an explicit argument in the utility function of the government. As a consequence, benevolent behaviour is replaced (or complemented) by self-interest: social welfare considerations could take a back seat if the government were sufficiently rewarded with political support from interest groups.

What would the benefits of an international trade agreement look like under the political-economy approach? Ethier identifies distinct political reasons for an agreement: it serves governments to get credit for the reduction in foreign trade barriers.[15] The rationale is explained most easily by comparing an international trade agreement with unilateral liberalisation. In the latter case, a government would be blamed by the import-competing industry for the rising level of imports. At the same time, it would not get any political support from the export industry, even if foreign governments also liberalised unilaterally: the *direct* connection between reduced domestic barriers and improved access to foreign markets would not exist. In the case of a trade agreement, however, the blame of the import-competing industry could be offset by the credit that the government gets for

[14] Or, as Maggi and Rodríguez-Clare (1998), p. 576, put it: "[...] a government may prefer to leave the door open to [...] domestic pressures rather than foreclose them" because "[it] ends up at least as well off in the political equilibrium as under free trade." Indeed, the famous model by Grossman and Helpman (1994), discussed in Chapter 4, explicitly assumes such an intrinsic desire.

[15] See Ethier (2003, 2002a). His argument is in the tradition of Hillman and Moser (1996). Bagwell and Staiger (2002, 2000), in contrast, claim that the benefits of an international trade agreement under the political-economy approach are the same as under the traditional economic approach: they are exclusively driven by terms-of-trade considerations. In other words, while political concerns increase the realism of the model, they do not offer any separate explanation for an international trade agreement. Following Bagwell and Staiger, however, one is again confronted with substantive critique as regards the relevance of the terms of trade.

having opened up foreign markets. Indeed, governments regularly praise an international trade agreement for its creation of additional export opportunities. On the other hand, they are silent on the (politically sensitive) aspect of domestic market opening, although economic theory shows that this aspect is responsible for substantial social welfare gains.

The political-economy approach in the formulation of Ethier has a lot of intuitive appeal. The creation of additional export opportunities may actually have been the driving force behind the many multilateral trade rounds after the Second World War. Chart 2.2 shows that the weighted average tariff for manufactures in developed countries has come down from about 40 percent after the conclusion of the GATT in 1947 to only four percent after the Uruguay Round.

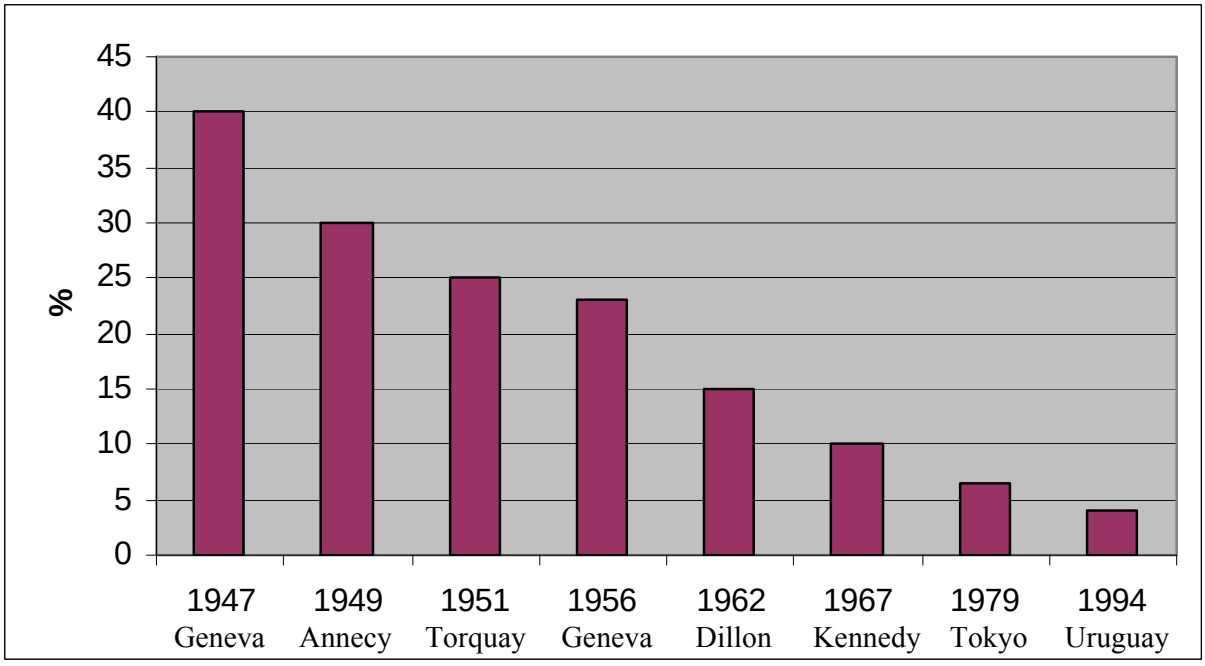

Chart 2.2: Weighted average tariff rate for manufactures in developed countries[16]

However, even after half a century of trade liberalisation, tariffs are still not eliminated. Furthermore, Chart 2.2 is insofar misleading as the average tariff (a) is much higher in developing countries, (b) is much higher for agricultural products, (c) conceals tariff peaks for individual products, and (d) abstracts from all non-tariff barriers. In particular, the study of permanent (i.e. long-term) protection in Chart 2.2 completely ignores temporary (i.e. short-term) protection. Whereas the level of permanent protection has

[16] Adapted from Senti (2000), p. 220. The names denote the multilateral trade rounds.

decreased since the conclusion of the GATT, there is no such assessment as regards temporary protection. In contrast, the use of some flexibility instruments has substantially increased over time.[17]

A rise in temporary protection could simply be the mirror image of lower permanent protection. Obviously, governments derive some benefits from protection, and they might resort to temporary means once permanent import barriers have to disappear. However, why would they agree to abandon permanent barriers if they seemingly did not want to give up protection? A possible explanation sounds like this: the multilateral reduction of permanent protection is a signal *à la* Ethier that export interests play an important role in the strategy of the government ("look, we have opened up foreign markets for you"). At the same time, however, the government satisfies import-competing sectors by the prospect of temporary protection. While this strategy could finally provoke a protectionist foreign response, there is no clear-cut connection. Therefore, domestic exporters may not blame their government.

The fact that a reduction in permanent barriers could entail more temporary import restrictions is not the only possible linkage between the two forms of protectionism. The rules on temporary protection are also decisive for the readiness of governments to take permanent liberalisation steps in the future. If these rules were generous, the willingness for permanent tariff cuts would *ceteris paribus* be greater than under a regime in which temporary protection is almost impossible. In the first case, governments would know that they could replicate some effects of permanent protection by temporary restrictions. In this sense, the impressive reduction in tariffs portrayed in Chart 2.2 could simply be a reflection of the ample possibilities for temporary deviation from negotiated liberalisation.

2.2 Flexibility in practice: a first look at the instruments

In this study, the term "flexibility instruments" is used for trade policy tools that provide governments with trade policy flexibility. Not all trade policy tools are flexibility instruments. This section will select the latter from a compilation of the former. Arguing that trade policy flexibility is defined as the ability of governments to decide unilaterally

[17] See Chapter 3. See also Ethier (1998), p. 4, who calls the use of trade remedies (safeguard, antidumping, and countervailing duty measures) a "new protectionism". He argues that "[w]ith the freedom to conduct traditional tariff policy progressively constrained by multilateral agreements, protectionist pressures have increasingly found outlets in the new protectionism."

when to introduce temporary import restrictions, a flexibility instrument is a trade policy tool that allows effecting this ability.

Once the flexibility instruments are identified, they have to be analysed in a uniform framework and with respect to each other. This is a precondition for accommodating all aspects of the institutional design of flexibility, and it is important for any attempt to suggest reforms to this design. Since there is presumably a certain degree of substitutability between individual instruments, it does not make sense to base reform proposals for a particular instrument on an isolated analysis of this instrument. Any effect intended by such proposals might be swept off by an evasion manoeuvre to other instruments.[18]

It follows that it is crucial to have a complete list of all flexibility instruments currently available. A two-step procedure will be applied for this purpose. Firstly, a "long list" is presented. This list includes all trade policy tools that might remotely be considered as flexibility instruments. Secondly, I define criteria in order to select those trade policy tools from the long list that truly meet the demands of an instrument intended to provide trade policy flexibility. It will be surprising to see that the resulting "short list" consists of only four flexibility instruments: safeguard measures, antidumping, countervailing duties, and the violation of WTO agreements.

2.2.1 The long list

The WTO agreements are full of regulations that cover the application of policy tools for trade restriction. I have collected as many as possible, and they can be found in the first column of Chart 2.3. Note that the list ignores policy tools related to products that are not traded under the ordinary GATT regime: in order to focus attention on the essence of flexibility, this study does not consider any special regimes of trade, such as those for agriculture, textiles, or services.[19]

My list corresponds closely to similar lists in two literature articles, Kleen (1989) and Finger (1998). Kleen entitles his work "The Safeguard Issue in the Uruguay Round – A

[18] Despite this reasoning, there are far-reaching reform suggestions that rely on an isolated analysis of a single flexibility instrument. See, among others, Lee and Mah (1998) on the Safeguard Clause, or Palmeter (1991) on antidumping.

[19] This does not mean that *all* trade in these products is effected by a special regime.

Comprehensive Approach", and his list consists of "various safeguard instruments and measures".[20] Finger, on the other hand, calls the components of his list "provisions that allow trade restrictions". The entries of Kleen and Finger can be found in the second and third column of Chart 2.3, respectively.

Trade policy tool	Kleen (1989)	Finger (1998)
VI - Antidumping	x	x
VI - Countervailing duty	x	x
XI:2b - Standard for classification		x
XII - Balance of payments		x
XVIII:A - Infant industry	x	x
XVIII:B - Balance of payments	x	x
XVIII:C - Infant industry	x	x
XVIII:D - Infant industry	x	x
XIX - Safeguard Clause	x	x
XX - General exception		x
XXI - Security exception		x
XXIII:2 - Retaliation		x
XXIV:6 - Regional integration		x
XXV:5 - Waiver	x	x
XXVII - No contracting party		x
XXVIII - Renegotiation Clause	x	x
XXXIII - Accession		x
XXXV - Non-application	x	x
Grandfather Clause	x	
Voluntary Export Restraint (VER)	x	
Unbound tariff	x	
Binding overhang		
Subsidy	x	
Violation of agreements		

Chart 2.3: Policy tools for trade restrictions[21]

There is not much divergence between the lists of Kleen and Finger. Finger seems to be more complete as regards explicit GATT articles while Kleen brings in policy tools such as unbound tariffs and subsidies that are either not part of the GATT text or, as in the case of subsidies, more subtle in their impact. The omission of Voluntary Export Restraints (VERs) in Finger's list is probably due to their ban in the Uruguay Round. Similarly, as

[20] Note that his use of the term "safeguard measure" is broader than mine.
[21] All articles relate to the GATT.

regards the Grandfather Clause, the respective protocol[22] is not in force any more. As a consequence, both VERs and Grandfather Clause are not dealt with in my study.

The last policy tool in my list is the violation of WTO agreements. While Kleen and Finger do not mention it, it is obvious that WTO members also apply measures that are not in accordance with explicit WTO rules. In order to restrict their imports temporarily, they sometimes violate agreements. In fact, these violations are a pivotal feature of the institutional design of trade policy flexibility.

2.2.2 The short list

Is it useful to look at all trade policy tools provided in Chart 2.3 when analysing the institutional design of flexibility in the world trading order? Probably not. Even though it is essential to take a broad view due to the substitutability issue, there are some distinct requirements that an instrument must fulfil in order to provide trade policy flexibility as defined above. These requirements will now serve as selection criteria. I have identified six that seem to be plausible to me, and any trade policy tool has to fulfil them cumulatively before it can be considered as a flexibility instrument.

(1) Deviation from initial concessions

The intrinsic interest in flexibility depends on the existence of an international trade agreement. If there were no such agreement, flexibility would be ubiquitous, and the question of its institutional design would not arise. A trade agreement consists of concessions: governments agree not to behave in a particular trade-distorting way any more. Where there is no concession, there is no agreement in a narrow sense, and the flexibility issue is irrelevant. The first requirement for a flexibility instrument is, therefore, that it involves a deviation from initial concessions.

This requirement is not fulfilled by two policy tools from the long list that have been termed "unbound tariffs" and "binding overhang". Unbound tariffs are tariff headings for which a binding agreement has not been concluded. A binding overhang, on the other hand, concerns a tariff heading for which a respective agreement exists, but in which the

[22] See the Protocol of Provisional Application of the GATT 1947, Para. 1:b.

bound rate is above the applied rate.[23] In both cases, a government could increase the tariff in order to introduce temporary import restrictions. However, since such a tariff increase would not represent a deviation from initial concessions,[24] the two trade policy tools are not considered as flexibility instruments.

(2) Temporary import restriction

As the term "flexibility" implies, this study does not concern policy tools used to permanently change the terms of an international trade agreement. Instead, the focus is on instruments that enable temporary deviations from initial concessions *without* altering the contents of an agreement. Therefore, a variety of entries in the long list can be eliminated. The most illustrative one is the Renegotiation Clause of Article XXVIII GATT. This article, termed "Modification of Schedules", has three different layers: Paragraphs 1 to 3 describe the procedure for a renegotiation of concessions at three-year intervals; Paragraph 4 allows renegotiation at any time, given the authorisation of the contracting parties; and Paragraph 5 enables a country to raise import barriers at any time by modifying its schedule of concessions, provided that it reserves this right by regular notification at three-year intervals.[25]

All layers are based on a permanent modification of concessions, which is difficult to revoke. Therefore, they do not constitute a flexibility instrument. A flexibility instrument offers temporary protection that is rapidly available and can promptly be terminated, without the burden of modifying the schedules of concessions. As Messerlin (2000, p. 162) puts it, renegotiation under Article XXVIII is a "disproportionate" instrument for the aim of temporary import restriction.

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[23] An overview of the prevalence of unbound tariffs and binding overhang for industrial products can be found in François and Martin (2002). While developing countries have unbound tariffs on up to 90 percent of MFN imports, most developed countries have bound virtually all of their tariffs. Regarding the binding overhang, however, developed countries are less ideal: 46 percent of all MFN imports of New Zealand and Canada enter under headings where the tariffs bound are above the rates applied. The respective values for other countries are: 32 percent (Australia), 18 percent (EC), 1 percent (Japan), and 14 percent (US).

[24] As regards the binding overhang, an increased tariff is not in deviation from initial concessions as long as it does not exceed the bound rate.

[25] Such a reservation has been made by a steadily increasing number of contracting parties in the past, see Hoda (2001). For the period from 1 January 2000 to 31 December 2002, 43 contracting parties – including the EC and the US – made such a reservation.

Other provisions that drop out of the long list due to their permanent character are Article XXIV:6 GATT (withdrawal of concessions at the time of the formation of a customs union or a free-trade area), Article XXXIII GATT (terms of accession to be agreed between a new member and the contracting parties), and Article XXXV GATT (non-application of the GATT between particular contracting parties).

(3) No approval needed

Remember again that trade policy flexibility is defined as the ability of a government to decide *unilaterally* when to introduce temporary import restrictions. This decision capacity would be nullified if a restriction were made dependent on the approval by other countries, notably by those that might henceforth be negatively affected. The third requirement for a flexibility instrument is, therefore, that it does not need external authorisation.

The most prominent entry on the long list that does not satisfy this requirement is the so-called waiver in Article XXV:5 GATT, which has been superseded by Article IX of the Agreement on the Establishment of the WTO. Under exceptional circumstances, contracting parties may decide to waive an obligation imposed on a WTO member, provided that such a decision is taken by a three-fourths majority of the contracting parties.[26] Hence, a waiver-based import restriction can never be the consequence of a unilateral decision.

In addition to the waiver, some other trade policy tools in Chart 2.3 can be eliminated on external authorisation grounds. This applies to Sections A, C, and D of Article XVIII GATT, which cover governmental assistance to economic development (the famous "infant industry" support). Furthermore, it applies to XXIII:2 GATT and the respective provisions of the DSU, which set forth the conditions for a retaliatory withdrawal of concessions after a WTO member has violated its obligations. These conditions exclude any unilaterally determined action.

[26] The requirement of a three-fourths majority was introduced in the Uruguay Round. The original GATT text had a two-thirds majority of votes cast and the additional requirement that such majority comprises more than half of the contracting parties. Between 1948 and 1994, 113 waivers had been granted, see Finger (1998).

(4) Discrimination by intent

Whenever a cross-border transaction is treated less favourably than a similar transaction within borders, there is discrimination. Trade policy could be conceived as the set of regulations framing cross-border transactions. If these regulations *aimed at* effecting a less favourable treatment of imports relative to domestic products, trade policy would be discriminatory by intent.

In fact, trade policy for the better part involves intended discrimination. It wants to improve the position of domestic firms relative to foreign competitors. However, there are exceptions: not all trade policy measures have such an intent. Some policies are motivated by other goals than discrimination. For example, an import ban on a particular product would not be regarded as discriminatory treatment if the sale of similar products by domestic firms were forbidden, perhaps due to health regulation. In other words, the intent behind this import ban would not be the protection of import-competing industries.

If a trade policy tool were barred from being based on discriminatory intent, it could not provide trade policy flexibility. The ability of the government to decide on import restrictions would be impaired too much: exogenous factors would determine the availability of the device. Thus, Articles XX GATT (on general exceptions) and XXI GATT (on security exceptions), but also Article XI:2b GATT (on restrictions to apply standards or regulations for the classification, grading or marketing of commodities) are no flexibility instruments.[27] Their purpose explicitly is non-discriminatory. This does not mean, however, that they could not be abused: they might be invoked by referring to non-discriminatory goals, but in essence be a hidden mechanism for protecting import-competing sectors. Yet since such action is against the spirit of the mentioned articles, trade policy flexibility would not be derived from the articles themselves, but from their violation.

(5) Relevance

Those trade policy tools that have lost their relevance due to a fundamentally changed global economic environment are not useful for providing trade policy flexibility. A

[27] Finger and Schuknecht (1999) provide some data on the use of these devices (see their Annex, Table QR-A1). They list notifications of respective measures. However, their information is only indicative since the GATT does not require that countries report these measures.

fundamental change has been, for example, the gradual move from fixed-exchange-rate regimes with high rigidity to more flexible exchange rates in many parts of the world. Although Articles XII and XVIII:B GATT are still available for import restrictions in order to defend the balance of payments, the first one is not used any more, while the use of the second one is rare and on a steady decline.[28] The Uruguay Round Understanding on the Balance-of-Payments Provisions of the GATT confirms this tendency by limiting the scope for their use.

Furthermore, Article XXVII GATT is not relevant. It provides for a withdrawal of concessions *vis-à-vis* a government that has not become or has ceased to be a contracting party. Both instances are rare in the history of the GATT and the WTO.

(6) No financial transfer

The protection of import-competing interests does not necessarily depend on a device that raises the price of imports. The quantity of imports can also be reduced by bringing down the price of domestic products. This price cut could be implemented by a production subsidy for the import-competing industry. While such a subsidy does not seem to be suspect at first glance, it is indeed an indirect trade policy tool.

Should subsidies be treated as a flexibility instrument? In my opinion, no. While the government has access to budgetary means that could be applied for trade policy purposes, the problem is twofold: Firstly, subsidies have to be financed by taxpayers, but any tax is unpopular.[29] Secondly, the disposition of financial means shows up in the public accounts. While the public does not necessarily understand tariffs as protectionist devices for organised interests,[30] a monetary transfer has the appearance of favouritism. In conclusion, while a subsidy could in principle provide flexibility, its political price is too high to be considered as a true flexibility instrument.

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[28] The annual reports of the *Committee on Balance-of-Payments Restrictions* confirm that there has been a strong tendency to phase out existing restrictions under Article XVIII:B since 1995. See the Documents No. WT/BOP/R/10 (4 December 1995), WT/BOP/R/19 (5 November 1996), WT/BOP/R/37 (12 November 1997), WT/BOP/R/44 (24 November 1998), WT/BOP/R/47 (27 September 1999), WT/BOP/R/55 (23 November 2000), WT/BOP/R/59 (11 October 2001), and WT/BOP/R/67 (19 November 2002).

[29] A subsidy would also exist if government revenue were foregone or not collected. While this means that no tax is necessary to finance the subsidy, the revenue forgone could be missing elsewhere – and therefore cause a tax increase.

* * *

The six requirements introduced above have considerably shortened the list of potential flexibility instruments in Chart 2.3. The remaining devices are the Safeguard Clause (Article XIX GATT), antidumping (Article VI GATT), countervailing duties (Article VI again), and the violation of WTO agreements. Only these four instruments fulfil all my requirements. Chart 2.4 summarises and slightly expands the requirement evaluation: for each entry on the long list, the requirements fulfilled are marked by an asterisk, whereas those not fulfilled are emphasised by a cross. The four flexibility instruments are in bold. They will be thoroughly analysed in the following chapters.

[30] Many consumers may believe that tariffs are for the protection of themselves since they keep off foreign products that are allegedly of low quality.

Trade policy tool	Deviation	Temporariness	No approval	Discrimination	Relevance	No financial transfer
VI - Antidumping	*	*	*	*	*	*
VI - Countervailing duty	*	*	*	*	*	*
XI:2b	*	X	*	X	*	*
XII	*	*	*	*	X	*
XVIII:A	*	*	X	*	*	*
XVIII:B	*	*	*	*	X	*
XVIII:C	*	*	X	*	*	*
XVIII:D	*	*	X	*	*	*
XIX - Safeguard Clause	*	*	*	*	*	*
XX	*	X	*	X	*	*
XXI	*	X	*	X	*	*
XXIII:2	*	*	X	*	*	*
XXIV:6	*	X	*	*	*	*
XXV:5	*	*	X	*	*	*
XXVII	*	X	*	*	X	*
XXVIII	*	X	*	*	*	*
XXXIII	X	X	*	*	*	*
XXXV	X	X	*	*	*	*
Grandfather Clause	X	X	*	*	X	*
VER	*	*	*	*	X	*
Unbound tariff	X	*	*	*	*	*
Binding overhang	X	*	*	*	*	*
Subsidy	X	*	*	*	*	X
Violation of agreements	*	*	*	*	*	*

Chart 2.4: Fulfilment (*) and non-fulfilment (**X**) of requirements

2.3 Trade policy flexibility in context

The term "flexibility" figures prominently in the literature on international relations and international economics. Not surprisingly, its precise meaning differs widely among authors. In this section, the use of the flexibility term both in this study and in the literature is structured by relating it to one single framework, introduced by Abbott, Keohane, Moravcsik, Slaughter and Snidal (2000).[31]

In fact, the contribution of Abbott *et al*. uses the term flexibility only marginally.[32] However, the central theme of their considerations – legalisation in international relations – may be understood as the perfect antipode to flexibility in a broad sense. According to Abbott *et al*., the ideal type of legalisation in international relations consists of an institutional design that maximises "obligation", "precision", and "delegation". Obligation means that governments are legally bound by an international agreement. The agreement must not be disregarded as preferences change. Precision characterises an agreement that unambiguously defines what is expected from participating governments. The scope for interpretation is thereby narrowed. Finally, delegation means that contracting governments transfer authority regarding implementation and dispute resolution to an independent body.

Obviously, there is no such ideal type of legalisation in the world trading order. The WTO agreements depart from it in all of the three dimensions introduced above. These departures might be conceived as constituting the overall quantity of flexibility *in its broadest sense*. Accepting this view, it should be possible to subsume the different concepts of flexibility in a narrower sense, found in my study and in the literature, under the departures from legalisation along the dimensions defined by Abbott *et al*.

Before turning to the literature, I start with my own concept of flexibility, the trade policy flexibility. It has been defined as the ability of governments to decide unilaterally when to introduce temporary import restrictions after an international trade agreement has been concluded. This flexibility is a departure from legalisation in both the obligation and the delegation dimension: it relaxes the obligation to reduce the level of import restrictions

[31] This is not to say that their framework is perfect or unanimously accepted. However, I find it useful due to its simplicity and explanatory power.

[32] It appears once on p. 409.

and it lowers the level of delegation in the world trading system, due to the government's freedom to decide. It should be noted, however, that while trade policy flexibility impairs obligation and delegation, it does not (necessarily) eliminate them. For instance, trade policy flexibility is not meant to relax the obligation to conduct the temporary import restriction in the least distorting way. As argued right at the beginning of Chapter 1, trade policy flexibility can be subordinated to MFN treatment. Furthermore, the task to determine whether the MFN (or any other) obligation is respected can be delegated to an independent authority, such as the Dispute Settlement Body (DSB) of the WTO.

Koremenos, Lipson and Snidal (2001) would call my flexibility concept as being "adaptive", allowing members to respond to unanticipated shocks or special domestic circumstances while preserving the existing institutional arrangements.[33] Such a policy response has been formally modelled, for instance, by Bordo and Kydland (1995, 1996). They consider an environment in which a country's gain from a multilateral agreement is affected by infrequent, irregular, and transitory negative shocks, such as wars or banking crises under a gold standard. They show how countries make use of escape clauses that allow a temporary suspension of convertibility in order to better deal with these shocks.

Barfield (2001), who criticises "the imbalance between the WTO's consensus-plagued, inefficient rule-making procedures and its highly efficient dispute settlement system – an imbalance that creates pressure to 'legislate' new rules through adjudication [...]" (p. 1), requests a very different kind of flexibility. He wants a dispute settlement procedure that returns to the tradition of diplomacy, which was prevalent in the pre-Uruguay-Round days. In particular, he wants procedures " [...] *forcing* mediation and conciliation on issues that clearly divide WTO member states and are likely to have politically explosive consequences that would damage the system [...]."[34] Furthermore, he suggests a "[...] blocking mechanism at the end of the DSU process that would set aside Appellate Body decisions when a substantial minority of WTO members registered disagreement with the

[33] The three authors supervised a large-scale project on the "rational design" of international institutions (see the special issue No. 4, Vol. 55 of *International Organization*), where they defined flexibility as one of five key dimensions within which institutions may vary. The others are membership rules, scope of issues covered, centralisation of tasks, and rules for control. Flexibility is generally seen as an expression of how institutional rules and procedures accommodate new circumstances.

[34] p. 19. Emphasis added.

decision of the [DSB]."[35] What kind of flexibility is this in the eyes of Abbott *et al*.? The obligation to stick to initial concessions is not directly impaired by Barfield's proposals. However, the delegation dimension is crucially affected: if governments kept control over the dispute settlement process, there would be no binding third-party adjudication any more. Rather, the process would become one of political bargaining.

Cottier (2002) and Cottier and Takenoshita (2003) take Barfield's imbalance judgement as the starting-point, but arrive at a different conclusion as regards reform. The adjustment of the imbalance between the efficient dispute settlement on the one hand and the inefficient rule-making on the other hand should focus on the inefficient part, and not on the efficient one.[36] Again, they suggest some kind of flexibility, but their flexibility concerns the legislative response to DSB decisions. If there were, as Barfield explores, a fear of excessive law-making by panels and the Appellate Body, it ought to become easier for WTO members to react by rapidly modifying the respective agreement(s). Any unintended effect of adjudication could then be avoided. They propose the introduction of a weighted voting principle for such purposes, while leaving the traditional multilateral trade rounds operating under consensus.

Although this proposal is diametrically opposed to Barfield's, it is again primarily about the delegation dimension of Abbott *et al*. Governments are obliged to stick to their concessions, but if it turned out that the initial agreement is flawed in any respect, they could rapidly change it, even if their were no consensus. The role of panels and the Appellate Body would be limited to mere adjudication, while any undesired law-making could be rectified without delay.

Following Koremenos, Lipson and Snidal (2001), Cottier's flexibility might be called "transformative": the institutional design has built-in arrangements to transform itself over time. In addition to weighted voting, another important variable with regard to transformative flexibility is the time horizon of international agreements. Based on early work from outside the international relations theory (e.g. Gray 1978, Dye 1985 or Harris and Holmstrom 1987), Koremenos (2001) compares an indefinite agreement with a series of regularly renegotiated agreements and puts forth some testable hypotheses as to when

[35] p. 19. While these proposals have provoked harsh criticism (see e.g. Hudec 2002, Steger 2002), they are reflected in a recent contribution by the US and Chile regarding the reform of the DSU, see Document No. TN/DS/W/28, 23 December 2002, and Chapter 5 of this study.

each type is more probable. In another article, Koremenos (2001a) develops a model in which the parties are able to learn over time about benefits and costs of an agreement. The learning process reduces uncertainty, and the parties are finally willing to extend the agreement indefinitely.

Nothing has been said thus far on the departure from legalisation along the precision dimension of Abbott *et al*. An international agreement that is not precise is incomplete:[37] there is discretion with regard to interpretation. If governments wrote an imprecise agreement because it is impossible (or: too costly) to increase the degree of specification, they might be willing to delegate the authority for "filling the gaps" to an independent body, such as the DSB. To the extent that this delegation is exhaustive, little flexibility is left for governments. However, a low level of precision can also be chosen on purpose: precision may not be desirable. As Abbott and Snidal (2000) argue, this should be particularly true if the future were uncertain instead of risky in the sense of Knight.[38] Governments might then prefer to leave an international agreement imprecise in order not to be caught in unfavourable initial concessions in the face of unforeseeable developments. As soon as problems of interpretation occurred, governments would come together and renegotiate.

2.4 Trade policy flexibility and private rights

It has been argued that prerequisites for temporary import restrictions impair trade policy flexibility. Prerequisites are economic circumstances that must prevail before imports may be restricted.[39] However, these prerequisites may not be the only potential source of restraint for trade policy flexibility. Danger could also lurk in the concept of private rights. This would be the case if trade policy flexibility were dependent on the intergovernmental character of the world trading system. It is probably correct to claim that this character predominates today. The WTO Appellate Body itself argues that "[t]he

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[36] See also Ehlermann (2002a).

[37] The lack of precision is, however, not the only reason why an agreement may be incomplete, see Chapter 4.

[38] For the classical distinction between risk and uncertainty see Knight (1921). While risk is a measurable probability that something happens, there is no probability distribution for something that is uncertain.

[39] Economic circumstances can be described by a broad variety of variables. Examples are growth rates, unemployment rates, or shifts in import penetration. Chapter 5 will detail the prerequisites for current flexibility instruments.

WTO Agreement is a treaty – the international equivalent of a contract."[40] A contract creates rights and obligations for the contracting parties only, and these parties are not economic individuals, but the member states represented by their governments. An introduction of private rights, however, would alter this intergovernmental character.

In this study, no judgement is provided as regards the desirability of introducing private rights in the context of the multilateral trading order. However, it is recognised that private rights could stop leading a shadowy existence in international trade relations at some future date. I do not expect such development to occur soon and therefore abstract from private rights subsequent to this section. Nonetheless, it seems worthwhile to check briefly the inherent relationship between these rights and trade policy flexibility. Are the former the coffin nail for the latter?

Private rights can have a variety of forms. A good deal of attention has recently been attracted, for example, by the so-called *Amicus Curiae Briefs*. They are common in the Anglo-Saxon legal tradition and consist of submissions made by private individuals to the adjudicating authorities.[41] The latter may, but need not, respect them in their determination of the case at hand. Another private right consists of increased transparency in the proceedings of the adjudication body: the meetings of WTO panels and the Appellate Body could become public.

Both *Amicus Curiae Briefs* and increased transparency need not conflict with my concept of trade policy flexibility. The conclusion could be different, however, with regard to still another private right: the right of economic individuals to file a trade-related complaint, either domestically or at the DSB. This right would imply that WTO agreements for the better part lose their intergovernmental character and instead have direct effect. There is a broad academic discussion on the desirability of this direct effect, with the most

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[40] *Japan – Taxes on Alcoholic Beverages*, WT/DS8,10,11/AB/R, Section F. Further support is provided, *inter alia*, by the adjudication of the European Court. The Court confirms that the "purpose of the WTO agreements is to govern relations between States or regional organisations for economic integration and not to protect individuals", see Case T-210/00, *Etablissement Biret SA v. EU Council*. Steger (2002) argues that "[t]he WTO is likely to remain a government-to-government organisation for the foreseeable future, and time is not ripe for allowing private persons to bring complaints against Member governments" (p. 569; emphasis eliminated).

[41] For a discussion in the WTO context, see Umbricht (2001), Mavroidis (2001), or Marceau and Stilwell (2001).

prominent advocates being the late Jan Tumlir and Ernst-Ulrich Petersmann, whereas notable criticism comes from John H. Jackson.[42]

What implication would the private right to file a complaint have for trade policy flexibility? The answer depends on the institutional design of flexibility, or more precisely: on the institutional design of individual flexibility instruments. The interface between direct effect and flexibility instruments has two components. The first component relates to the lawfulness of the instruments. Remember that WTO members do not only use devices that are in accordance with explicit WTO rules. In order to restrict their imports temporarily, they also commit violations. However, direct effect would have a deterring impact on the use of the violation instrument, particularly if the right to sue were exerted domestically: a government that violates WTO law could be confronted with the ruling from a court of its own country, which considerably increases the political pressure (up to the point of a constitutional obligation) to revoke its inconsistent trade policy. In the end, direct effect might lead to a substantially reduced number of violations. This in turn is the main argument in favour of its introduction. On the other hand, the lawful use of flexibility instruments that are explicitly provided for in WTO agreements (such as the Safeguard Clause) would not be impaired by private rights.

The second component of interface between direct effect and trade policy flexibility relates to compensation. Today, not all flexibility instruments have a compensation requirement: most of them can be used without indemnifying those who are negatively affected. However, whenever WTO rules envisage compensation, a potential private rights character of world trading rules would probably have an effect on the characteristics of compensation: it could change the group of claimants.

As long as WTO agreements represent an intergovernmental contract, any compensation is owed to countries as a whole, represented by their governments. Private individuals would have no separate claim. However, if the WTO agreements entailed direct effect, it may not be a country that has to be compensated, but instead the negatively-affected private individuals themselves. For example, if the US restricted steel imports, compensation could be owed to foreign steel exporting firms, and not to the home

[42] A good comparison of their arguments is provided in Cottier and Shefer (1998). The panel in *US – Sections 301-310 of the Trade Act of 1974*, WT/DS152/R, argues in Para. 7.72 that "[n]either the

countries of these exporters. Since trade compensation is hardly conceivable in this case,[43] the nature of compensation would have to change. Furthermore, not only foreign parties might have to be compensated: if an import restriction negatively affected domestic importers (such as processing firms or even consumers), they might be indemnified on the government's failure to ensure the openness of domestic markets.

What can be concluded from this short (and abstract) analysis? The introduction of private rights into the world trading order would have an impact on trade policy flexibility. Nonetheless, the two concepts need not conflict with each other. Depending on the design of individual flexibility instruments, there could be a peaceful coexistence, characterised by two features. Firstly, all flexibility instruments would have to be explicitly provided for in the WTO agreements. Violations would become much more the exception than the rule. Secondly, whenever compensation is owed, it would have to go straight to those who directly suffer from temporary import protection.

GATT nor the WTO has so far been interpreted by GATT/WTO institutions as a legal order producing direct effect."

[43] Trade compensation for negatively-affected private individuals would counteract the initial temporary protection.

3 The Empirics of Flexibility

The WTO Secretariat has a collection of data on the use of flexibility instruments.[44] However, this information has deficiencies in at least three respects. Firstly, the data are incomplete. For example, not all safeguard measures have been notified in the past.[45] Furthermore, numerous violations of WTO agreements have presumably remained undetected or, alternatively, have led to bilateral settlements that have never become public. Secondly, even if the data were complete, there would be severe difficulties of interpretation. It is hard to relate, for instance, the fact that there were 205 antidumping and eleven safeguard measures in 2002. These numbers are difficult to interpret individually, and it is even more difficult to compare them with each other, since they are only an indicator of the level of temporary protection afforded. In order to present a more complete picture of the actual use of trade policy flexibility, these numbers would have to be multiplied by some measure that reflects both the *breadth* and the *depth* of negatively-affected imports. As regards the breadth, the restriction could concern either a small subsector or, alternatively, a significant part of the economy. As regards the depth, the restriction might completely interrupt the import of the product in question or simply reduce its quantity to a certain degree. The third deficiency of the WTO data is that the numbers on the different instruments are not reported under the same premises. For example, an antidumping investigation against five countries is counted by the WTO Secretariat as five investigations. The same applies to countervailing duties. In contrast, a safeguard investigation is always reported as a single investigation, regardless of the number of export countries that are negatively affected.

While I attempt to overcome the third deficiency by resorting to another data source where appropriate, the elimination of the first and second deficiency is not within the scope of this chapter.[46] Given the limitations of my approach, any conclusion from the

[44] All data are available at www.wto.org.

[45] This was confirmed by the WTO Secretariat in February 2003.

[46] There is a good deal of high-level research that entirely abstracts from these deficiencies. For example, Bown (2002) makes a comparative study on the use of antidumping and safeguard measures. He counts 150 safeguard actions between 1947 and 1994 and writes on p. 48 without further annotation: "*To put this into context*, [...] GATT Contracting Parties imposed 132 definitive [antidumping] measures in 1993 alone!" (Emphasis added.)

empirical analysis has to be drawn with care. The chapter is intended to provide an *impression* of the use of flexibility instruments, and not a definitive evaluation.

3.1 The Safeguard Clause

The Safeguard Clause of Article XIX has been in use since the early days of the GATT history. For a considerable time, it was the most popular instrument for temporary import restrictions. As Chart 3.1 reveals, there were 19 definitive safeguard measures until the end of the fifties, 35 in the sixties, 47 in the seventies, 37 in the eighties, 29 in the nineties and 25 in the years between 2000 and 2002. On average, the instrument was used 3.3 times per year before the establishment of the WTO in 1995 and 4.9 times per year since then. The development in the use of the Safeguard Clause has been cyclical: notable peaks can be detected in the second half of the seventies and in the first years of the new millennium.

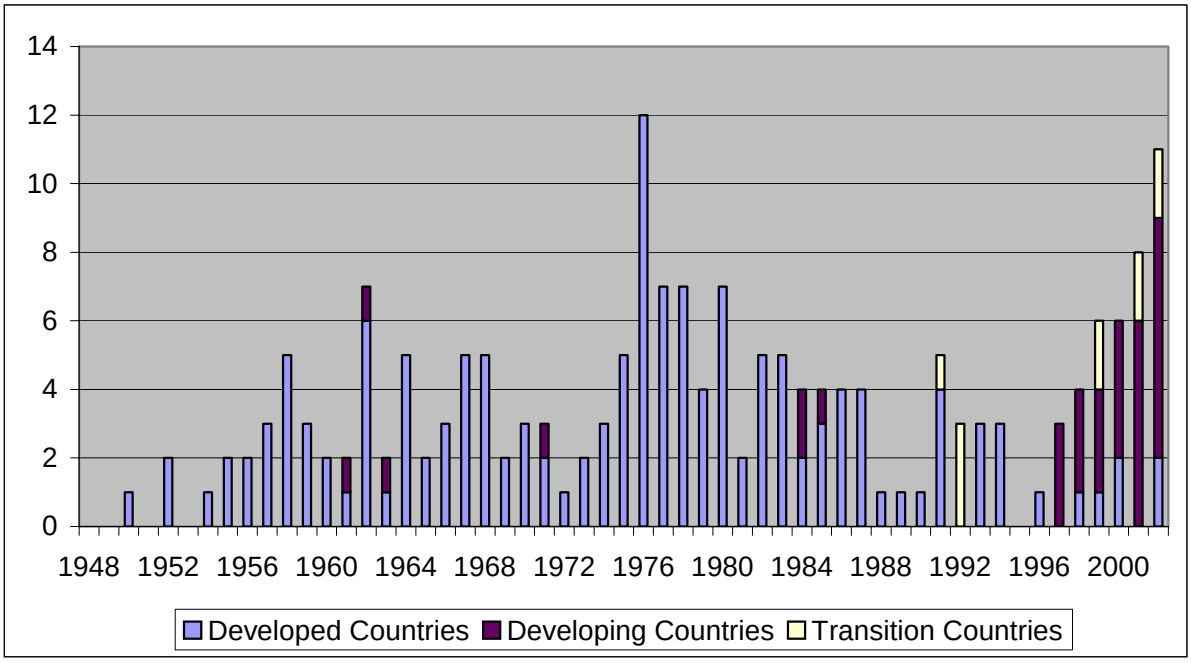

Chart 3.1: Definitive safeguard measures by reporting group 1948-2002[47]

[47] Data source: WTO (1995) and annexes to the reports of the *Committee on Safeguards* to the *Council for Trade in Goods*, dated 23 November 2000, 31 October 2001, and 4 November 2002, Documents No. G/L/409, G/L/494, and G/L/583, respectively. The reporting period ended on 28 October 2002. The classification of countries by development stage is taken from Miranda, Torres, and Ruiz (1998), see my Appendix 8.1.

The latest peak is substantiated by a significant number of investigations. Not all investigations lead to definitive measures, but even when they are terminated at an early stage, they have distorting effects on trade by causing uncertainty. In 2001, 15 investigations were notified to the WTO. The corresponding number for 2002 was 31. While these numbers are small in comparison with antidumping data (there were 276 antidumping investigations in 2002), they become impressive when multiplied (for comparative purposes) by the number of export countries that were negatively affected. In this case, Stevenson (2003) reports 53 investigations in 2001 and 132 in 2002.

While the peak in the second half of the seventies is explained by the global economic crisis,[48] the latest peak has been driven strongly by the US action on steel (investigations started in July 2001) and the subsequent response from trading partners, particularly from the developing world.[49] According to Stevenson (2003), steel accounted for 83 percent of all safeguard investigations in 2001 and again for 79 percent in 2002.

Safeguard actions were for a long time the exclusive domain of developed countries. Until 1995, developing and transition countries accounted for only eleven definitive measures. Since then, however, the picture has dramatically changed: out of 39 definitive measures between 1995 and 2002, developed countries were responsible for seven, developing countries for 26 and transition countries for six. What are the reasons for this development? As regards transition countries, they abandoned their managed trade regimes at the beginning of the nineties. Some of them became members of the GATT only at that time.[50] The more intensive use of the safeguard instrument by developing countries could have two reasons. Firstly, as mentioned in Chapter 2, those trade policy tools that had been specifically designed for the developing world (in particular Article XVIII:B GATT) lost their usefulness. Secondly, the Uruguay Round for the first time brought about substantial reductions in developing country tariffs. As a consequence, some countries resorted to alternative means of protection.

[48] Product coverage in the record year 1976 was broad, including e.g. motor vehicles, steel, certain apparel products, and footwear.

[49] For a background view on the *Steel* case see Durling (2002).

[50] The transition countries applying safeguard measures since the nineties are the Czech Republic, Slovakia, Hungary, Latvia, and Lithuania. The first three countries have been GATT members for a long time already, whereas Latvia and Lithuania became members in 1999 and 2001, respectively.

Chart 3.2 shows the annual number of countries[51] initiating safeguard measures. There is a lower degree of cyclical development than in Chart 3.1: until 1998, the number of countries was almost constant, oscillating between one and four. 20 different countries set definitive safeguard measures during this time. Only after 1998, the number of countries applying the safeguard instrument soared. There were five countries in 1999 and 2000, seven in 2001, and a record number of ten in 2002. However, after 1998, only two countries – Egypt (twice) and Latvia (once) – applied safeguard measures for the first time. Therefore, the rise in safeguard action in the last few years is not primarily due to transition and developing countries that are *for the first time* active in this field. Rather, it is due to countries which had been active before, but which have recently intensified their activity in this respect.

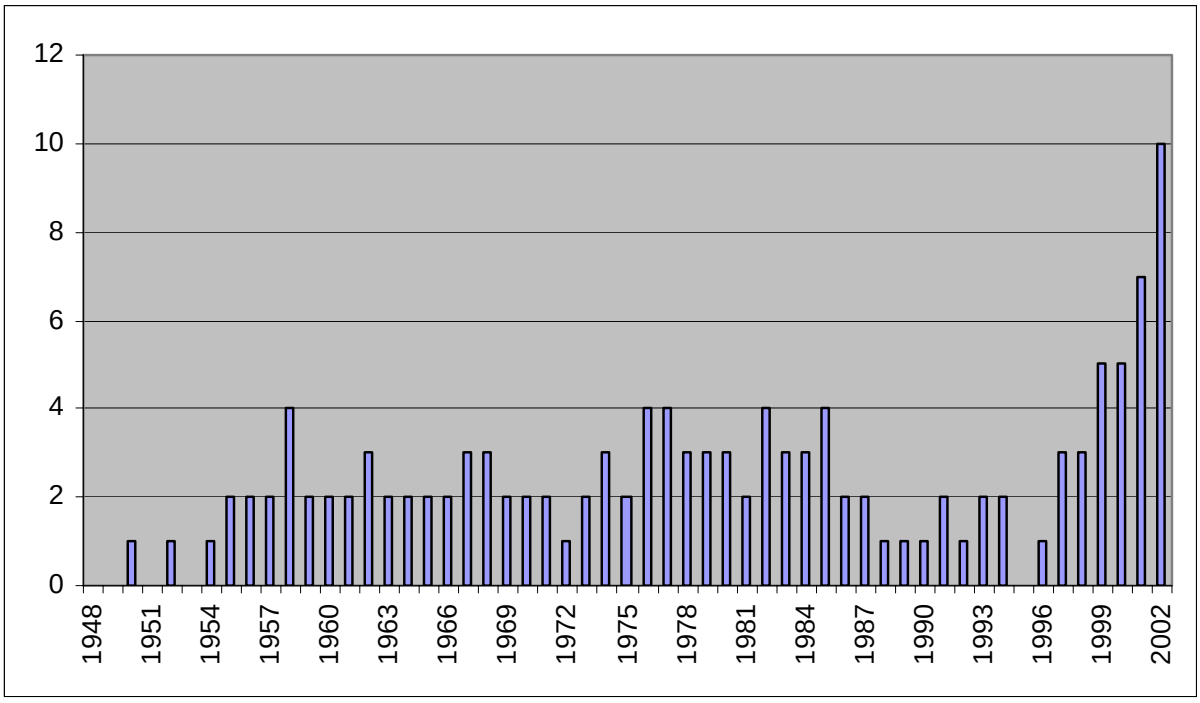

Chart 3.2: Number of countries applying definitive safeguard measures 1948-2002[52]

Which countries have been affected by safeguard measures? Safeguard action is in general required to be of a non-discriminatory nature.[53] This means that *all* foreign countries would be affected by a safeguard measure, even if they did not currently export

[51] For comparative purposes, current members of the EC (15) are not counted separately.

[52] Data source: WTO (1995) and annexes to the reports of the *Committee on Safeguards* to the *Council for Trade in Goods*, dated 23 November 2000, 31 October 2001, and 4 November 2002, Documents No. G/L/409, G/L/494, and G/L/583, respectively. The reporting period ended on 28 October 2002.

[53] See Chapter 5.

to the protected market: they might want to do so in the (near) future. However, it is obvious that actual exporters of the product in question are affected more directly than potential foreign suppliers. Therefore, the records on the safeguard measures notified indeed contain some information on negatively-affected countries. However, this information is sparse and does not suffice to provide a well-founded view on the question.[54]

Temporary import restrictions are often criticised for being extendable (or actually extended) over an unwarranted period of time. Therefore, the Uruguay Round Agreement on Safeguards contains explicit provisions on the maximum duration of safeguard measures. Before the conclusion of this agreement, however, the average duration of safeguard measures had already declined, as documented in Chart 3.3.

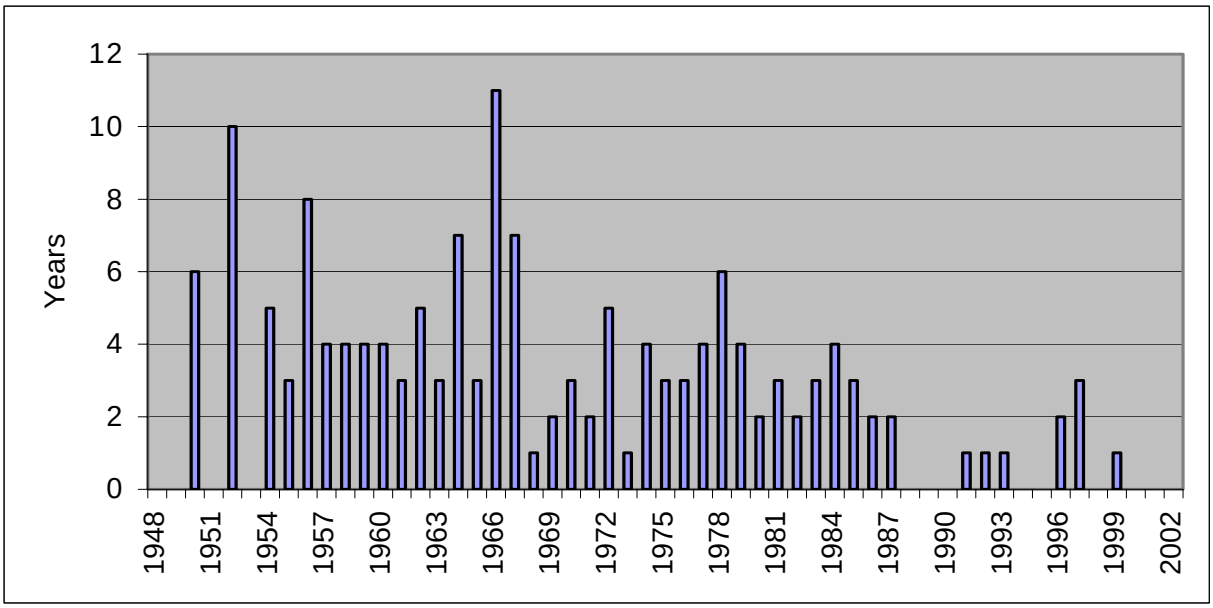

Chart 3.3: Average duration of safeguard measures by year of initiation[55]

The average duration decreased continuously from 5.5 years in the fifties to 4.6 years in the sixties, 3.4 years in the seventies and 2.6 years in the eighties. Although there are only

[54] WTO (1995) contains information on negatively-affected countries for 113 of 153 safeguard measures between 1947 and 1994. Since 1995, such records have not been kept any more. As regards the 113 cases for which information is available, the list of countries is probably incomplete in many cases.

[55] Averages are based only on those safeguard measures for which a termination has been notified. Years without value correspond to years without safeguard measures (1948, 1949, 1951, 1953, 1995) or to years with no data on their termination. Data source: WTO (1995) and annexes to the reports of the *Committee on Safeguards* to the *Council for Trade in Goods*, dated 23 November 2000, 31 October 2001, and 4 November 2002, Documents No. G/L/409, G/L/494, and G/L/583, respectively.

few data available for the post-Uruguay-Round time,[56] there is at least no indication that the average duration is again on the rise.

Since compensation plays an important role in this study, Chart 3.4 gives an overview of the number of safeguard measures that were accompanied by the provision of compensatory means. During the fifties and the sixties, compensation was provided in 16 out of 54 safeguard cases, which represents a ratio of 30 percent. After the sixties, compensation became rare, and the last reported incidence dates back to 1978. However, even if one assumed that there have been no *unnotified* compensation deals after 1978,[57] this would not mean that the compensation issue has become irrelevant. For example, potential compensation was explicitly discussed between the US and the European Communities (EC) in the aftermath of the US safeguard action on steel in March 2002.[58]

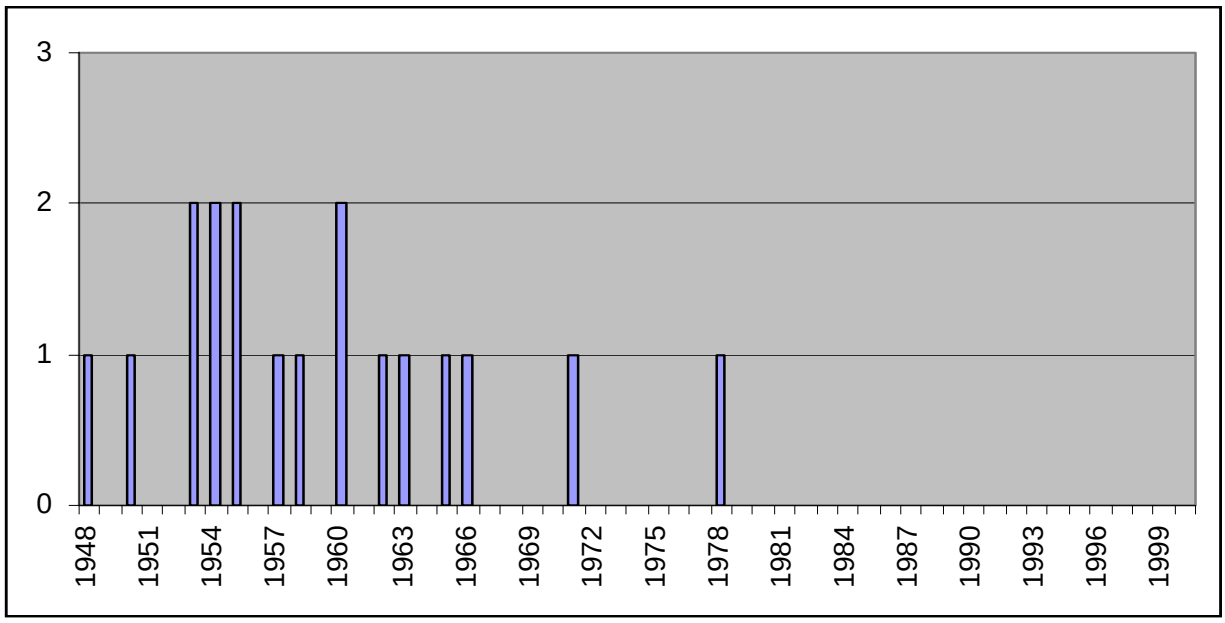

Chart 3.4: Number of safeguard measures accompanied by notified compensation[59]

[56] This has two reasons. Firstly, the latest annual reports of the *Committee on Safeguards* to the *Council for Trade in Goods* (dated 31 October 2001 and 4 November 2002) do not report the termination of measures any more (the respective column is missing). Secondly, some safeguard measures initiated since 1995 are not yet terminated.

[57] Under the new Agreement on Safeguards, Article 12:5 explicitly requests that any compensation deal be notified to the WTO Secretariat. The WTO Secretariat in Geneva confirmed in April 2003 that no such notification has been made since 1995.

[58] See a report of the *International Trade Reporter*, Vol. 19, No. 12, 21 March 2002.

[59] Data source: WTO (1995) and information from the WTO Secretariat (April 2003).

Safeguard measures have been taken in a broad variety of industries. Chart 3.5 shows the distribution for the period between 1948 and 2002. I have classified all measures using the Harmonised System (HS) sections to the best of my ability (the description of all HS sections can be found in Appendix 8.2).[60] The five dominant sectors account for 63 percent of all definitive measures. They are Foodstuffs (HS-section IV: 15 percent of all measures), Textiles (XI: 15 percent), Vegetables (II: 12 percent), Base Metals (XV: 12 percent), and Machinery (XVI: 9 percent).

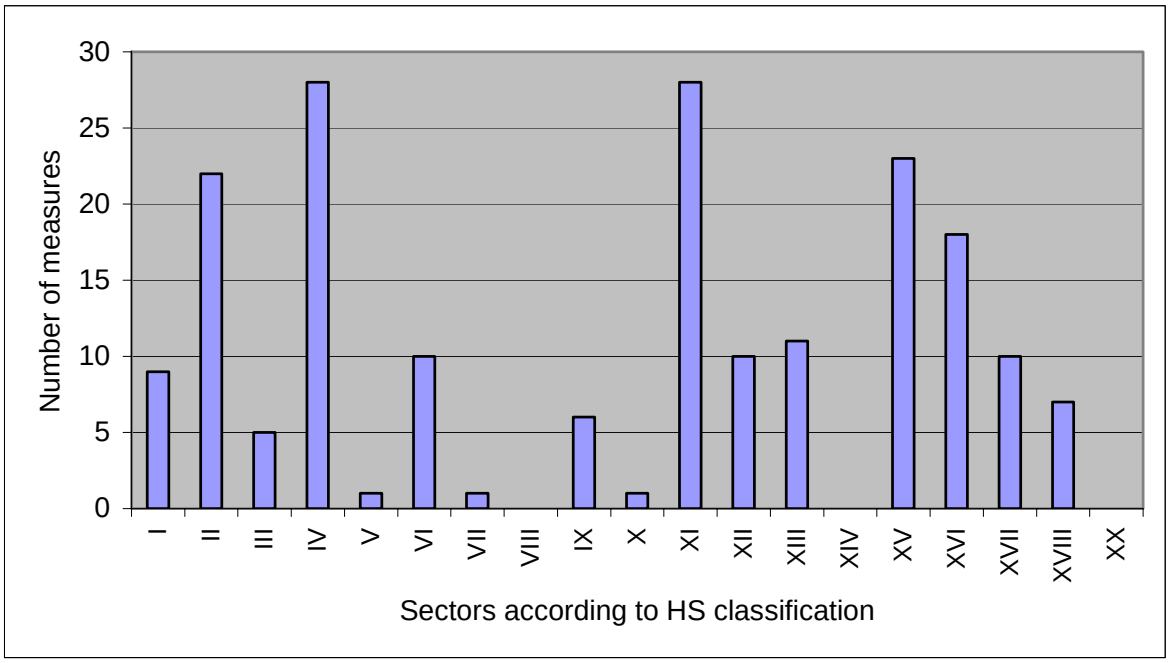

Chart 3.5: Sectoral distribution of definitive safeguard measures 1947-2002[61]

[60] For a few safeguard measures, the information available is simply not sufficient to ensure that the classification is correct.

[61] Data source: WTO (1995) and annexes to the reports of the *Committee on Safeguards* to the *Council for Trade in Goods*, dated 23 November 2000, 31 October 2001, and 4 November 2002, Documents No. G/L/409, G/L/494, and G/L/583, respectively. The description of all HS sections can be found in Appendix 8.2.

3.2 Antidumping

Chart 3.6 sheds light on the worldwide use of antidumping since the beginning of the eighties. Between 1980 and 2002, more than 4800 investigations were initiated. Almost 2500 of them resulted in definitive measures. Despite the Uruguay Round Agreement on Antidumping,[62] which had nurtured positive expectations regarding a restraint of the instrument, antidumping activity became more intense after the conclusion of the Round: the average annual number of investigations increased from 179 (between 1980 and 1994) to 270 (between 1995 and 2002), and the respective number of definitive measures rose from 82 to 157.

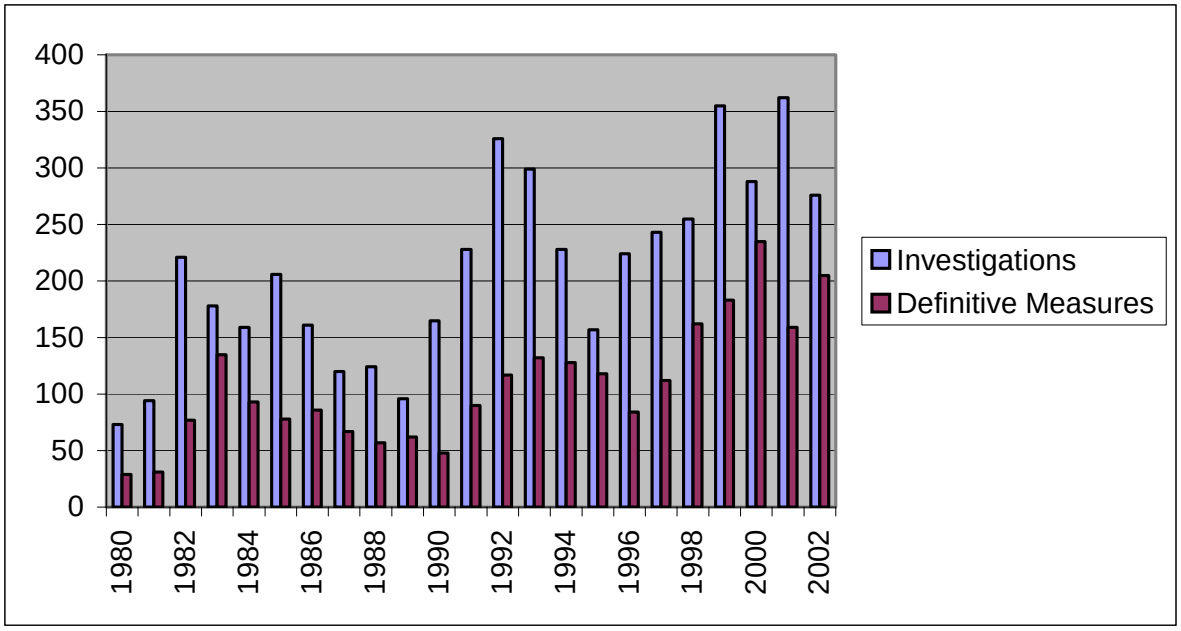

Chart 3.6: Number of antidumping actions 1980-2002[63]

Admittedly, part of this surge is explained by growing trade volumes. However, more attention should be drawn to the fact that the number of countries that apply antidumping has risen substantially over time, as detailed in Chart 3.7. In 1987, just after the beginning of the Uruguay Round, six countries[64] initiated investigations and five applied definitive

[62] See the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994.
[63] Data source: WTO website and Miranda, Torres, and Ruiz (1998).
[64] Current members of the EC (15) are not counted separately.

measures. In 1994, at the end of the Round, 19 countries initiated investigations and 13 introduced definitive measures. In 2002, the respective numbers were 24 and 20.

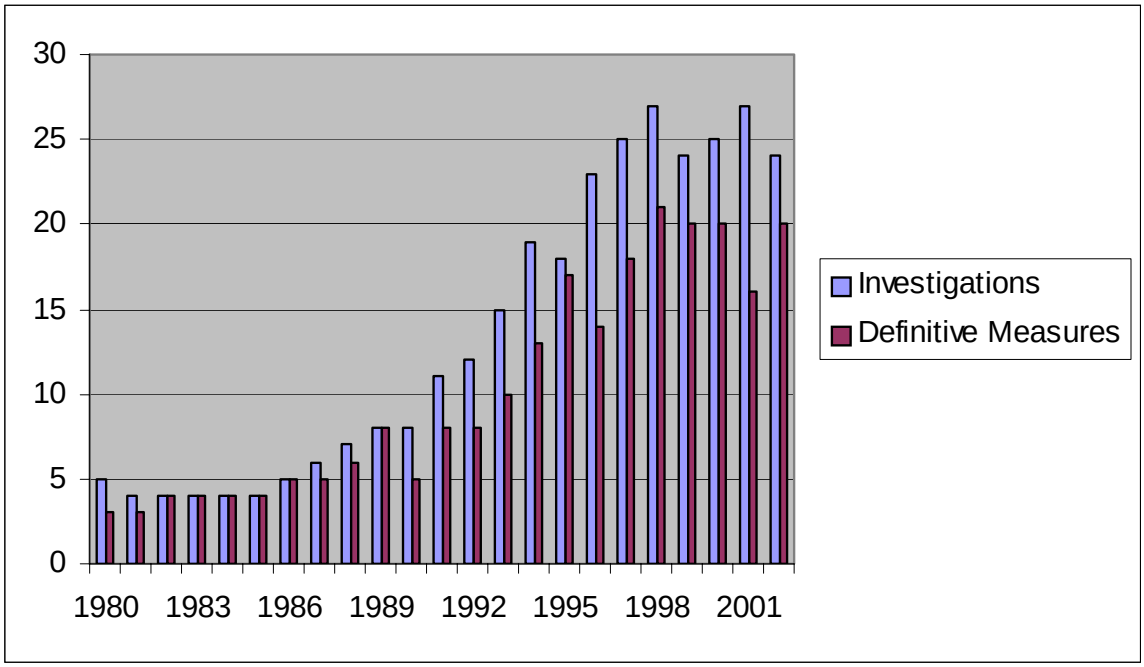

Chart 3.7: Annual number of countries initiating antidumping actions 1980-2002[65]

Who are the new users of antidumping? It is primarily the developing world that has recently acquired a taste for this flexibility instrument. This is confirmed by Charts 3.8 (a) and (b), which are drawn for investigations and definitive measures, respectively. Mexico and South Korea were the only developing countries to launch antidumping investigations in 1987, reporting 16 percent of all investigations. Mexico was the only country that introduced definitive measures, and this was limited to a single case. In 1994, developing countries were responsible for 43 percent of all investigations, and for 34 percent of definitive measures. Finally, in the last reporting year (2002), the percentages had increased to 63 and 61 percent, respectively. This means that almost two thirds of current antidumping actions emanate from the developing world, a region that was virtually absent in this field until the end of the eighties.

[65] Data source: WTO website and Miranda, Torres, and Ruiz (1998).

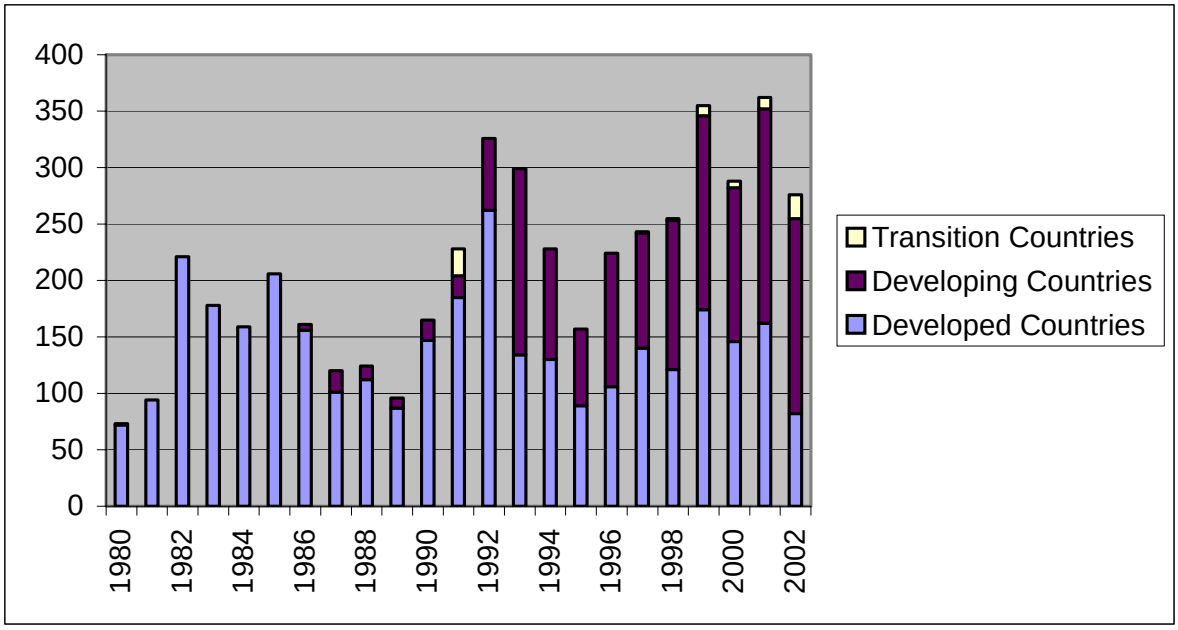

Chart 3.8 (a): Antidumping investigations by reporting group 1980-2002[66]

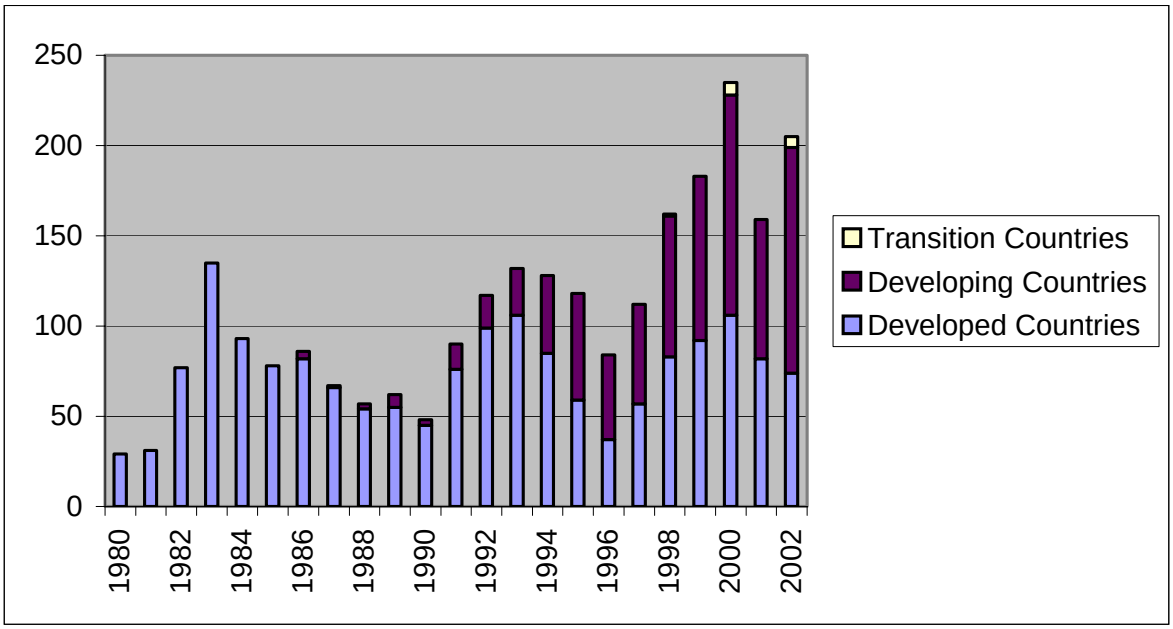

Chart 3.8 (b): Definitive antidumping measures by reporting group 1980-2002[67]

Is the rise in antidumping activity simply a reflection of increased GATT (or WTO) membership?[68] Appendix 8.3 shows that many developing countries have become new members since the beginning of the Uruguay Round: between 1987 and 2002, 39 of them

[66] See preceding footnote.
[67] See preceding footnote.
[68] In this case, the rise in antidumping measures would be explained by an enlarged data set.

acquired membership. This represents an increase of 63 percent in developing country membership. However, looking more closely at the data, it can be observed that these 39 countries were responsible for only 52 out of 769 investigations (i.e. 7 percent) originating in the developing world between 1987 and 2002. Therefore, the rise in antidumping measures since 1987 has not been caused by new membership, but by growing activity of those developing countries that had already been members of the GATT before the beginning of the Uruguay Round.

There is a notable congruence in the composition of reporting countries in the safeguard and the antidumping area. Both instruments were for a long time the exclusive domain of the developed world, but are now equally popular among developing countries. However, while antidumping had a high level of popularity in developing countries already prior to the conclusion of the Uruguay Round, the Safeguard Clause came into more frequent use only afterwards. This contrasts with the sequence in the developed world: there, the Safeguard Clause had been actively used long before the antidumping instrument became popular.

Who is affected by antidumping measures? Charts 3.9 (a) and (b) help to answer this question. Two aspects are noteworthy. Firstly, developing countries had been the target of antidumping action well before the time when they started to become active users of the instrument themselves. In 1987, 42 percent of all antidumping investigations and 55 percent of definitive measures were targeted against developing and transition countries. In 1994, the respective numbers were 75 and 66 percent.[69]

[69] Prusa (1999), p. 1, describes the developed country behaviour *vis-à-vis* the developing world as follows: "On the one hand, the US and EC preach that reducing government interference and accepting free markets will maximise growth and welfare. On the other hand, it often seems that just when developing countries begin to efficiently operate and become competitive in particular markets, industrialised countries shut down those precise markets with [antidumping measures]. 'Do as I say, not as I do' seems an apt description of the US and EC's view of the efficiency of government involvement in markets – at least with respect to antidumping."

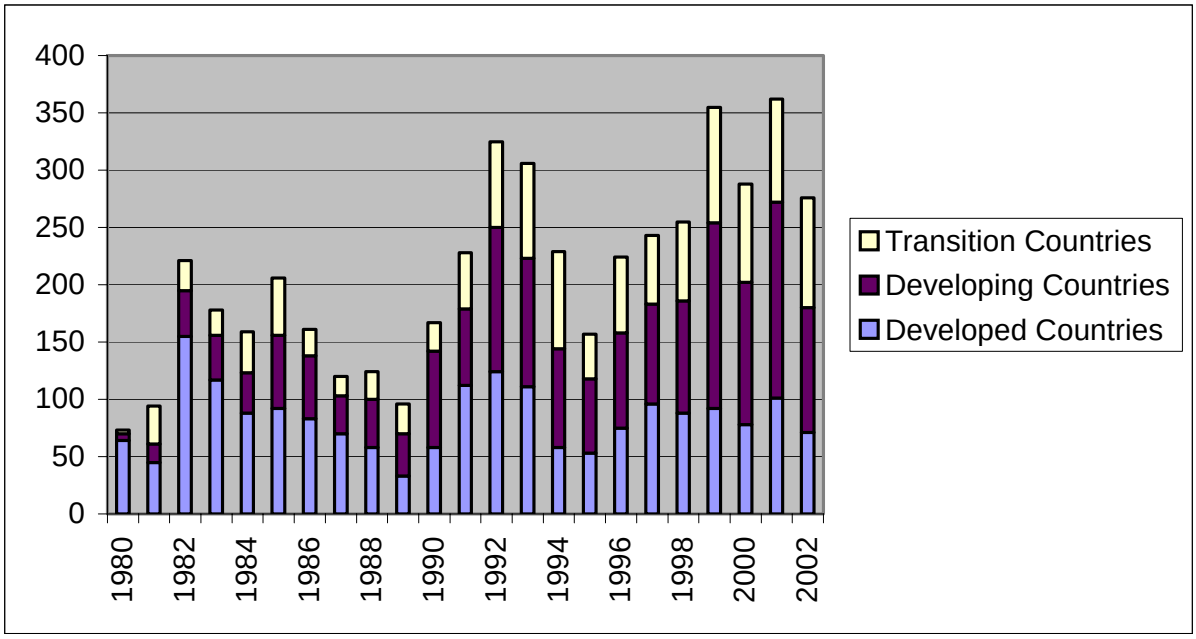

Chart 3.9 (a): Antidumping investigations by affected group 1980-2002[70]

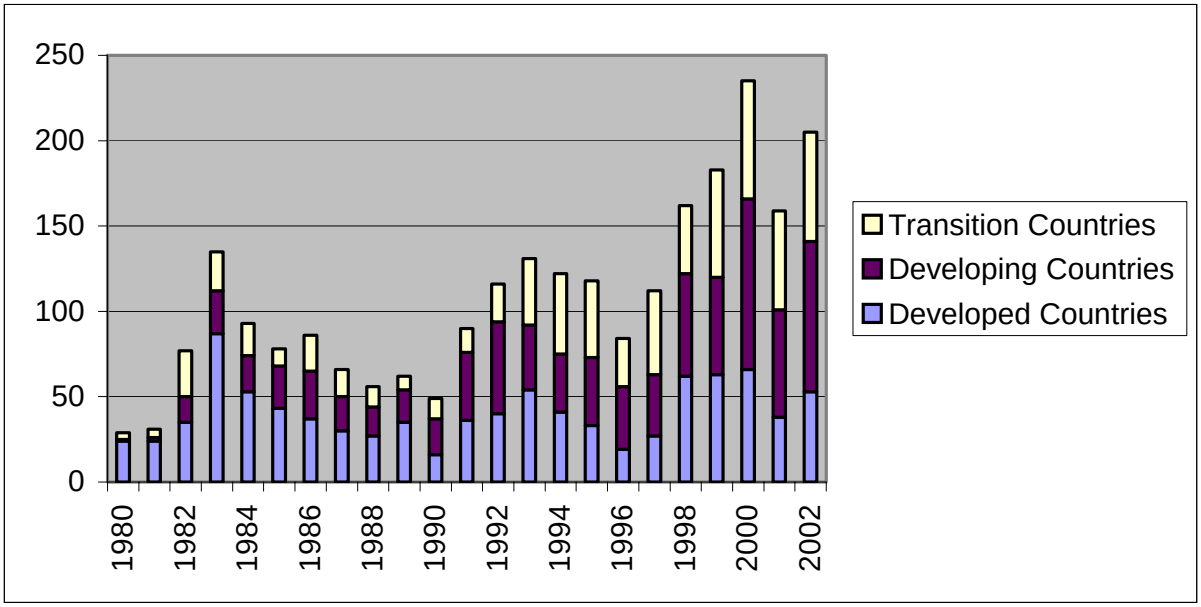

Chart 3.9 (b): Definitive antidumping measures by affected group 1980-2002[71]

The second aspect of interest is, however, that there has been considerable antidumping action against developed countries as well. The EC, for example, has been the target of 351 investigations and 189 definitive measures since the end of the Uruguay Round. For the US, the corresponding figures are 115 and 67. Furthermore, the pressure of

[70] Data source: WTO website and Miranda, Torres, and Ruiz (1998).

antidumping action against those developed countries that may be termed the "traditional users" of antidumping has recently increased. The traditional users include Australia, Canada, the EC, New Zealand and the US. In the eighties, 98 percent of all definitive antidumping measures originated in these countries.

How can an increased pressure against these countries be measured? Charts 3.10 (a) and (b) are drawn for antidumping investigations and definitive measures, respectively. For each traditional user, the bars indicate what I call the "reciprocity ratio". This ratio is calculated by dividing the number of cases where the firms of a country are confronted with foreign antidumping action by the number of cases in which the country itself applies antidumping.

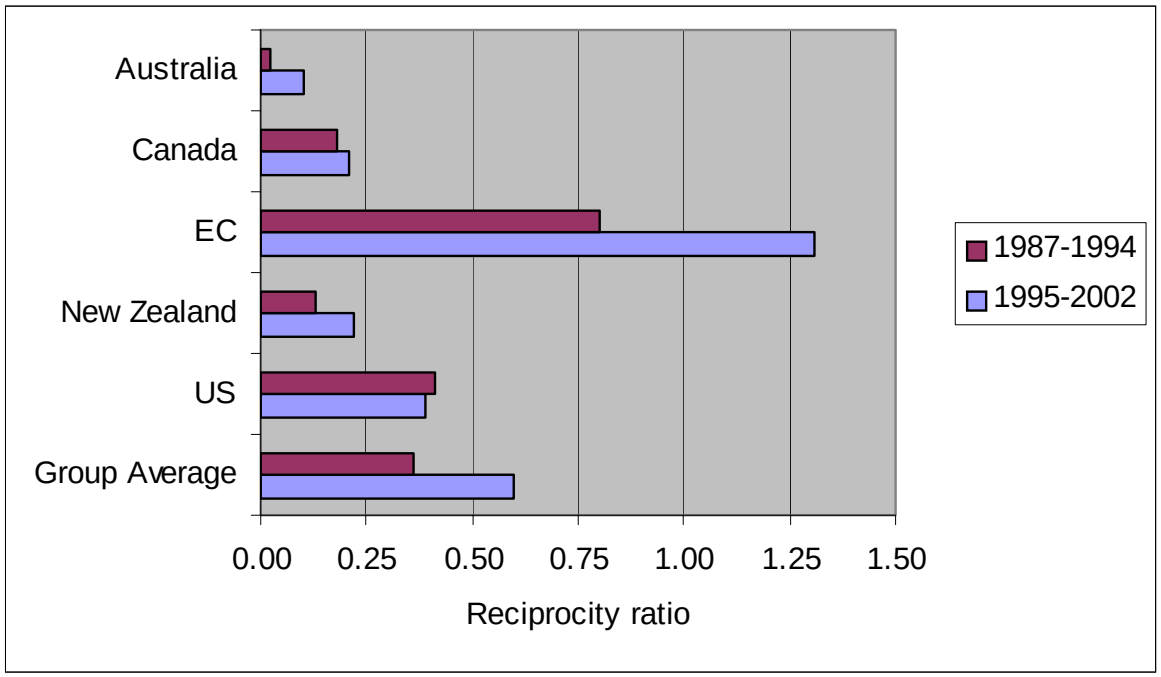

Chart 3.10 (a): Investigations: reciprocity ratios for traditional antidumping users[72]

[71] See preceding footnote.
[72] Calculations by myself.

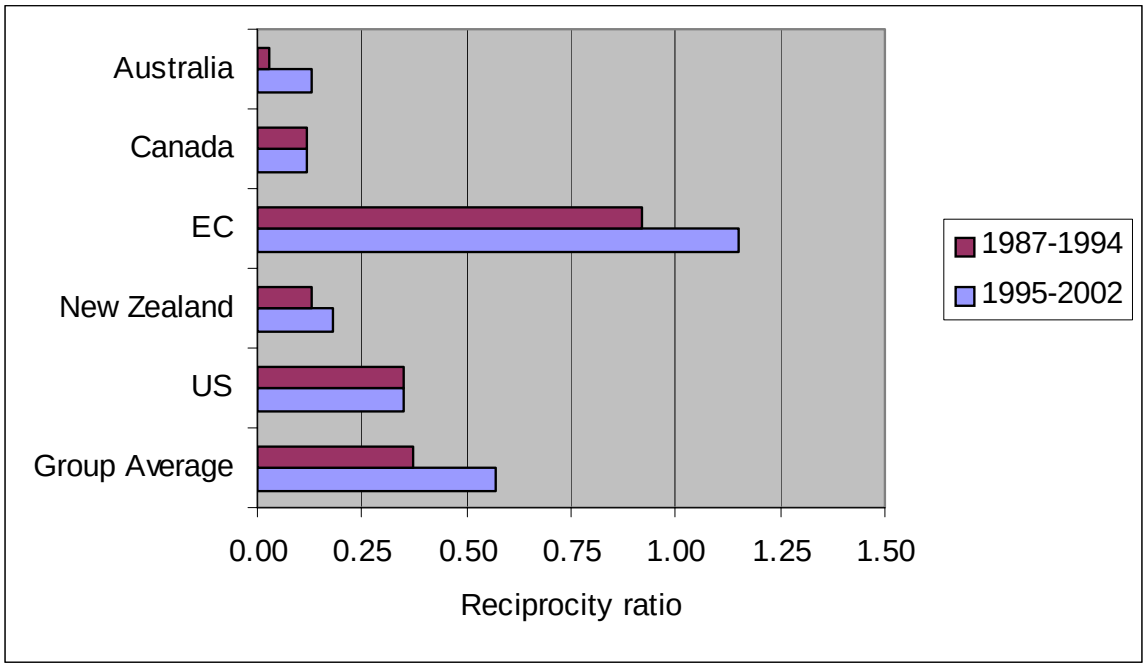

Chart 3.10 (b): Definitive measures: reciprocity ratios for traditional antidumping users[73]

Comparing the periods 1987–1994 and 1995–2002, many reciprocity ratios increased substantially. The rise is particularly substantial for investigations where the group average increased from 0.36 to 0.60. The latter ratio means that for every ten antidumping investigations of their own, traditional antidumping users are confronted today with six foreign investigations. The situation is most pronounced for the EC, which has a reciprocity ratio well above one and is therefore affected by foreign investigations more often than it conducts its own investigations.

Messerlin (2002) calculates that the average duration of antidumping measures is seven years in developed countries. A broad variety of industries is affected. Nonetheless, the bulk of activity concentrates on a few sectors. Chart 3.11 covers the period from 1987 to 2002. The top-five sectors according to HS classification (see Appendix 8.2) account for 79 percent of all definitive antidumping measures. In detail, the most important sectors are Base Metals (HS-section XV: 33 percent), Chemicals (VI: 18 percent), Machinery (XVI: 11 percent), Plastics (VII: 10 percent), and Textiles (XI: 7 percent). Remember that Base Metals, Machinery, and Textiles are also dominant in terms of safeguard action.

[73] See preceding footnote.

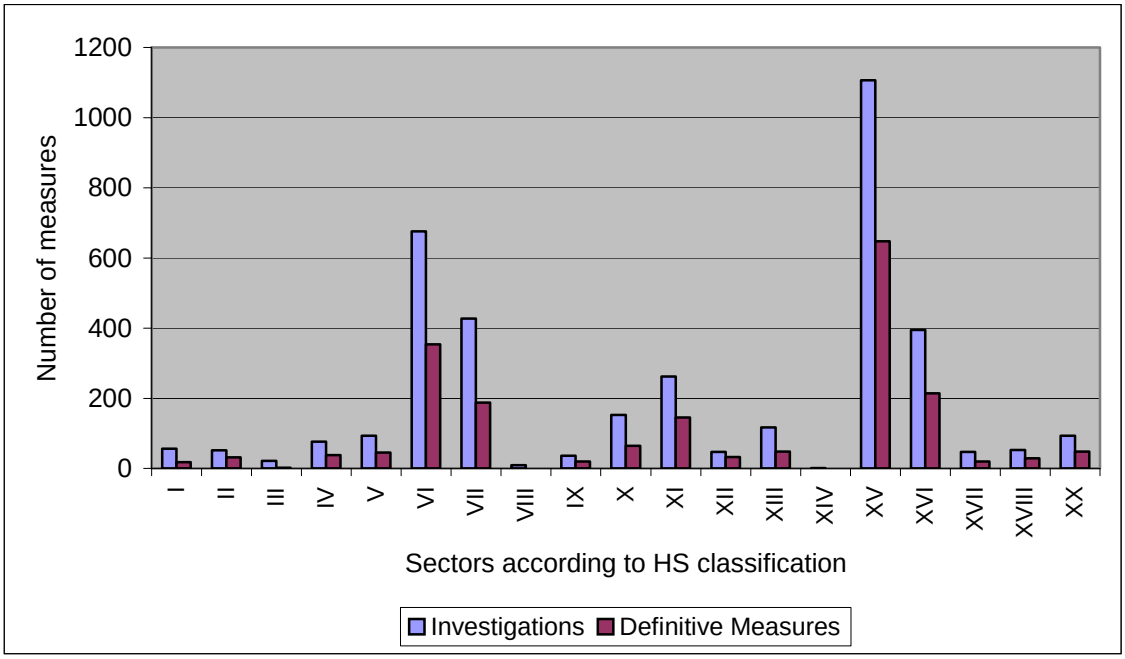

Chart 3.11: Sectoral distribution of antidumping activity 1987-2002[74]

3.3 Countervailing duties

According to Chart 3.12, 767 countervailing duty investigations were initiated between 1980 and 2002, of which 309 resulted in definitive measures.

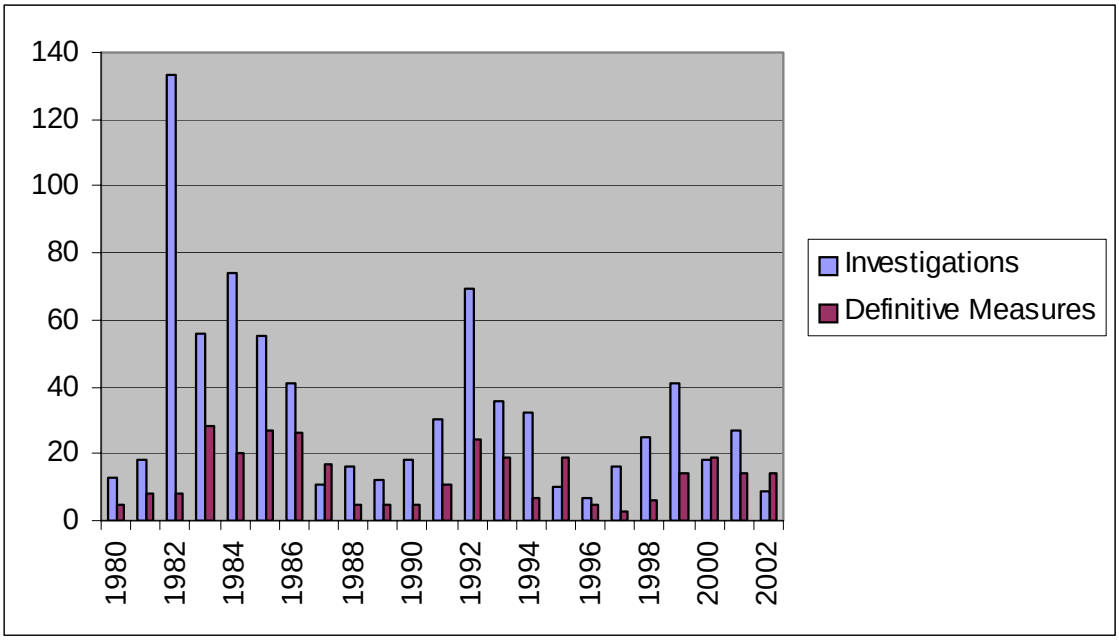

Chart 3.12: Number of countervailing duty actions 1980-2002[75]

In contrast to the development of antidumping, countervailing duty activity has not become more intense since the conclusion of the Uruguay Round: the average annual number of investigations decreased substantially from 41 (between 1980 and 1994) to 19 (between 1995 and 2002), and the respective number of definitive measures remained almost steady (14 compared to 12).

This observation corresponds to the fact that there was no rising trend in the number of countries applying countervailing duty actions during the nineties, again in contrast to antidumping. Chart 3.13 shows that three countries initiated investigations and three applied definitive measures in 1987, just after the beginning of the Uruguay Round. In 1994, seven countries initiated investigations and five introduced definitive measures. By 2002, the numbers had fallen to four and three, respectively. Overall, the number of countries with an active countervailing duty policy is low compared to the number of countries applying antidumping measures.

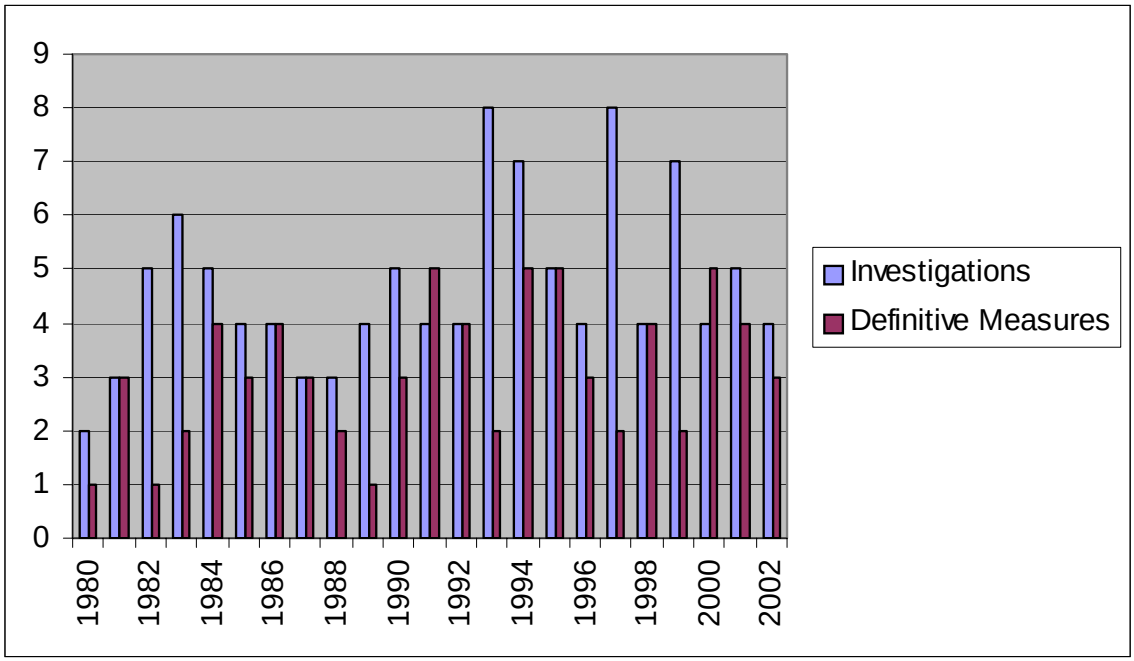

Chart 3.13: Number of countries initiating countervailing duty actions 1980-2002[76]

[74] Data source: WTO website and Miranda, Torres, and Ruiz (1998). The description of all HS sections can be found in Appendix 8.2.

[75] Data source: WTO website. The high number of investigations in 1982 is due to the activities of Chile (72 investigations) and the US (55) against Argentina (affected in 20 cases), Brazil (34), Mexico (9), and Peru (16).

[76] Data source: WTO website.

Who are these users of the countervailing duty instrument? Charts 3.14 (a) and (b) provide an answer.

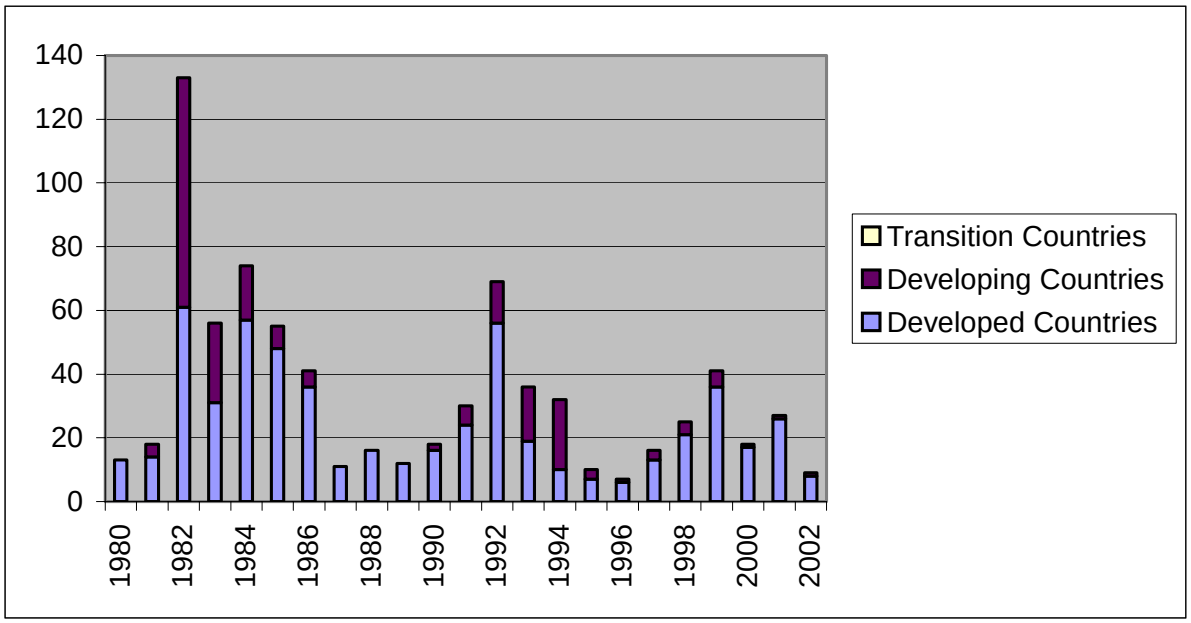

Chart 3.14 (a): Countervailing duty investigations by reporting group 1980-2002[77]

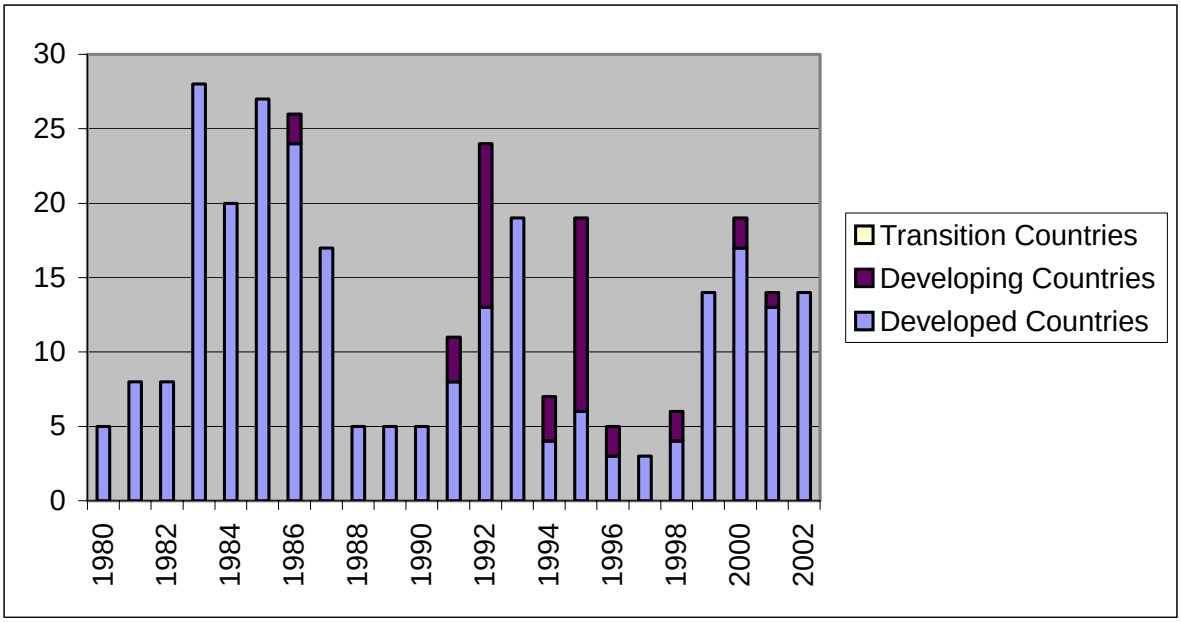

Chart 3.14 (b): Definitive countervailing duties by reporting group 1980-2002[78]

[77] Data source: WTO website. The classification of countries by development stage is taken from Miranda, Torres, and Ruiz (1998), see my Appendix 8.1.

[78] See preceding footnote.

The charts are noteworthy in three respects. Firstly, transition countries are completely absent from the countervailing duty arena: no single investigation or definitive measure has been reported. Secondly, developed countries dominate over the whole period. Thirdly, once more in sharp contrast to antidumping, the share of developing country activity is on the decline. Between 1980 and 1994, 31 percent of investigations originated in the developing world. In the period 1995 to 2002, this percentage decreased to twelve.

Who is affected by countervailing duty activity? As Charts 3.15 (a) and (b) show, it is mostly directed against developing countries. The Uruguay Round has not changed anything in this respect. Between 1980 and 1994, 59 percent of all investigations and 51 percent of definitive measures were targeted against the developing world. Since then, the respective percentage has risen to 61 both for investigations and definitive measures.

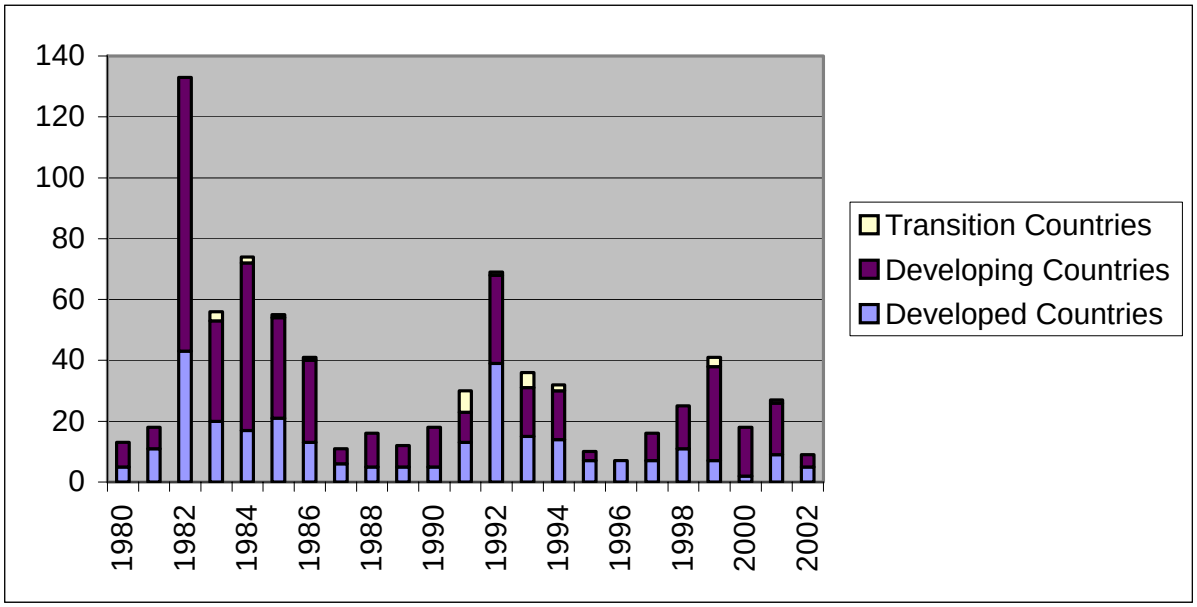

Chart 3.15 (a): Countervailing duty investigations by affected group 1980-2002[79]

[79] See preceding footnote.

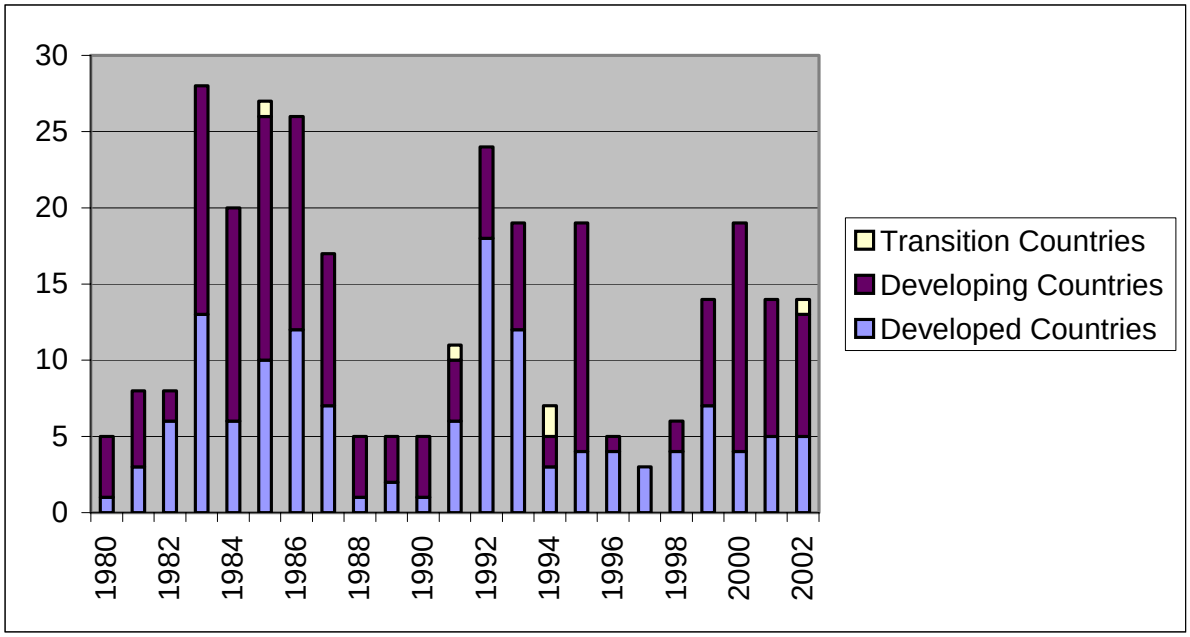

Chart 3.15 (b): Definitive countervailing duties by affected group 1980-2002[80]

Chart 3.16 displays the sectoral distribution of countervailing duty action, covering the period from 1980 to 2002. The top-five sectors together account for 81 percent of all definitive measures. Base Metals (HS-section XV) dominate with 44 percent, followed by Animals (I: 11 percent), Foodstuffs (IV: 10 percent), Vegetables (II: 8 percent), and Textiles (XI: 8 percent).

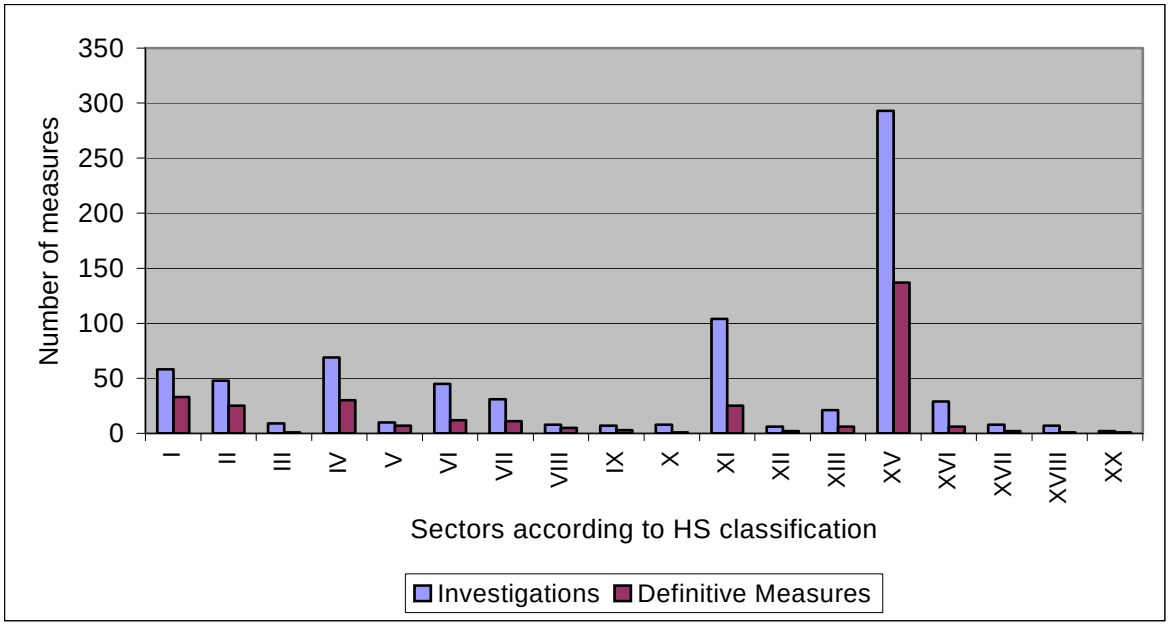

Chart 3.16: Sectoral distribution of countervailing duty activity 1980-2002[81]

3.4 The violation of WTO agreements

In contrast to the three lawful flexibility instruments analysed thus far in this chapter, the user of the violation instrument does not notify the action to the WTO Secretariat. It could be argued that this is no problem since the high level of trade interaction between WTO members guarantees that any violation is soon detected by those parties negatively affected. However, mere detection does not necessarily lead to notification in the sense of filing a complaint. Problems with incomplete data are therefore particularly pronounced: it is possible that many violations do not find their way into the statistics because affected countries are either unwilling (due to a bilateral deal) or unable (due to their economic or political dependence on the violator) to initiate a dispute settlement procedure. If there is no such initiation, the violation will never be officially registered since there is no *ex-officio* prosecution.[82] As a consequence, the following data, which are drawn from WTO dispute settlement statistics, tend to be biased downwards. On the other hand, however, not all violations represent import restrictions. As the *FSC* case[83] exemplifies, countries also violate the rules in order to promote their exports. Therefore, the actual number of violations overdraws their application as a flexibility instrument.

Chart 3.17 provides the number of complaints under the new DSU since 1995 and groups them by defendant country. 279 complaints were reported by 2002. The period is not long enough to recognise a clear trend. On average, there were 35 complaints per year, and the dominant defendants over the whole period were the US (75 times), the EC (39), Argentina (16), India (13), and Japan (13).

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[80] See preceding footnote.

[81] Data source: WTO website. See my Appendix 8.2 for the description of HS sectors.

[82] An indication of possible violations that have not (yet) been object of a WTO dispute settlement procedure could be drawn from national sources such as the *EC Market Access Database* (see http://mkaccdb.eu.int). There, EC exporters record market access obstacles all around the world, some of which may indeed be in violation of WTO rules.

[83] *US – Tax Treatment for 'Foreign Sales Corporations'* , WT/DS108.

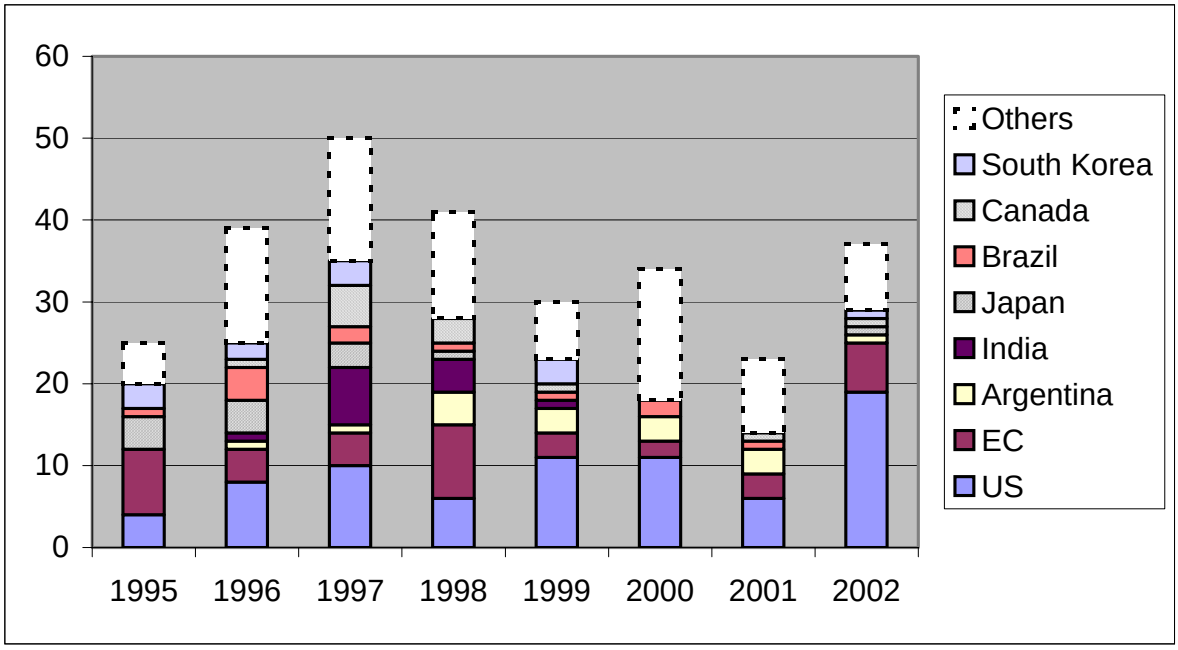

Chart 3.17: Annual number of complaints by defendant country 1995-2002[84]

As Chart 3.18 demonstrates, the somewhat cyclical development in the number of complaints (with a rise until 1997 and a subsequent decline until 2001) is reflected correspondingly in the number of defendants.

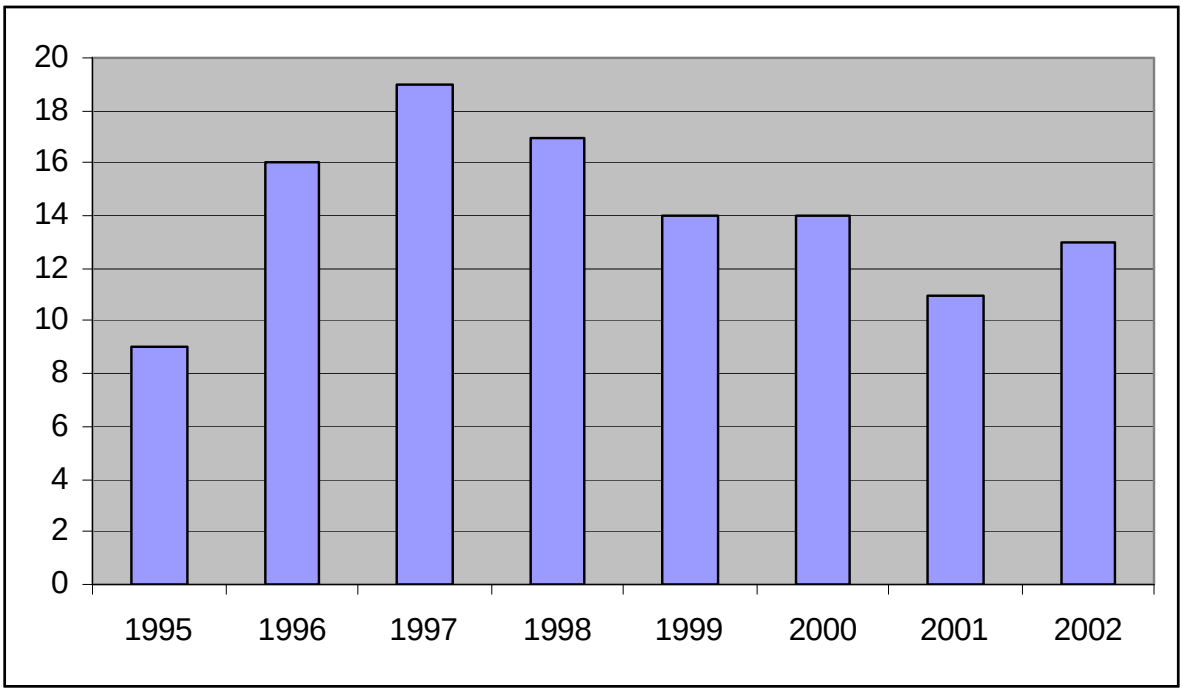

Chart 3.18: Annual number of defendants 1995-2002[85]

[84] Data source: Leitner and Lester (2003) and www.worldtradelaw.net.

In fact, the number of complaints and defendants is of limited interest only. Direct information on violations and violators would be more useful. The two preceding charts are of little significance as long as there is no indication of the outcome of the disputes: if most of them were finally decided in favour of the defendant, the number of complaints would be a bad approximation for the number of violations. However, Guzman (2003) analyses the 82 disputes decided by a WTO panel until July 2002 and concludes that 90 percent were won by the complainant.[86] This result in turn makes it possible to replace the terms "complaints" and "defendants" in the captions of Charts 3.17 and 3.18 by "violations" and "violators" without considerably reducing the level of precision.[87]

Who is affected by these violations? The answer can be inferred from the data on complainant countries. Chart 3.19 makes clear that there is a considerable congruence between defendants and complainants.

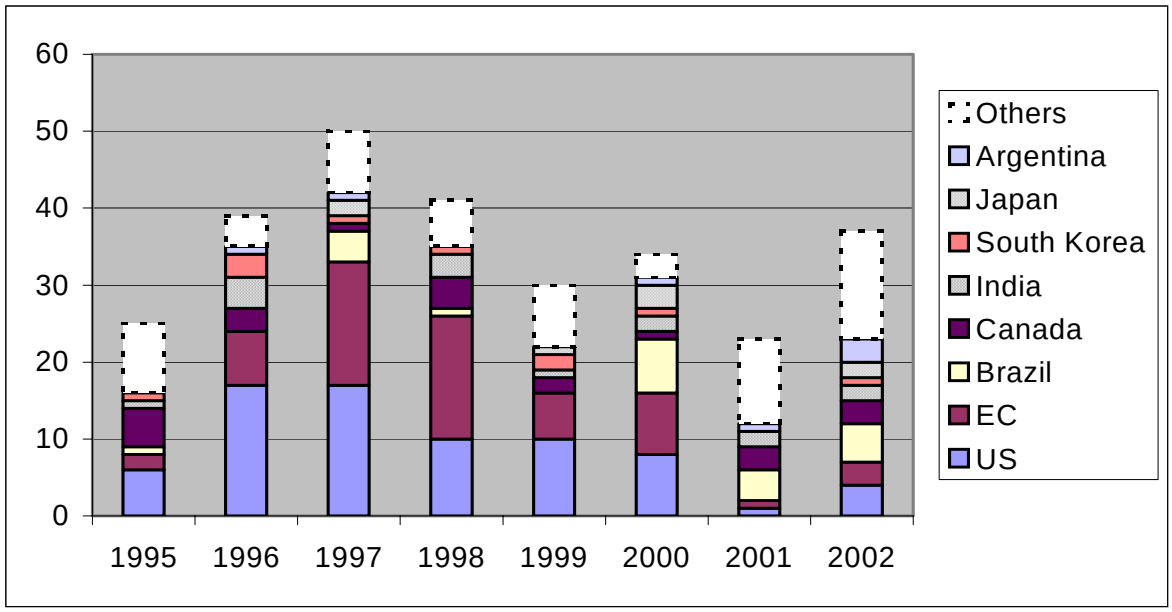

Chart 3.19: Annual number of complaints by complainant 1995-2002[88]

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85 Data source: www.worldtradelaw.net.

86 A case is deemed to be won if the panel concludes that the defendant has violated one or more of its obligations under WTO agreements. Reinhardt (2001), p. 180, notes: "[T]he parties already know what their obligations are: the [DSB] ruling is just a formality whose likely content the disputants could often agree on in advance." He observes a pro-complainant bias in those cases decided by a panel on the order of 4 to 1 for the GATT period. Ethier (2002) argues that defendants clearly won only two of the first 44 decisions under the WTO dispute settlement.

87 One would risk making a mistake if those disputes that have remained in the early stage of dispute settlement (i.e. where there has not been a panel decision) had a lower pro-complainant bias than those decided by a panel. However, I am not aware of any plausible reason why this should be so.

88 Data source: Leitner and Lester (2003) and www.worldtradelaw.net.

All major defendants are also major complainants (and *vice versa*). In particular, the US and the EC are the two main defendants and the two main complainants. Between 1995 and 2002, the US was a complainant in 73 cases and was followed by the EC (59), Brazil (22), Canada (22), and India (15).

The DSU emerging from the Uruguay Round has been praised for providing better opportunities for developing countries to enforce their rights.[89] They should now be able to bring violations to the attention of the world trading community more easily and to have them condemned by an independent body. Did these expectations come true? There is no unequivocal answer to this question.

Let me start with some indications that emphasise a positive development. Chart 3.20 shows that while high-income countries have been filing the large majority (63 percent) of complaints, low-income countries have brought forward 19 complaints.

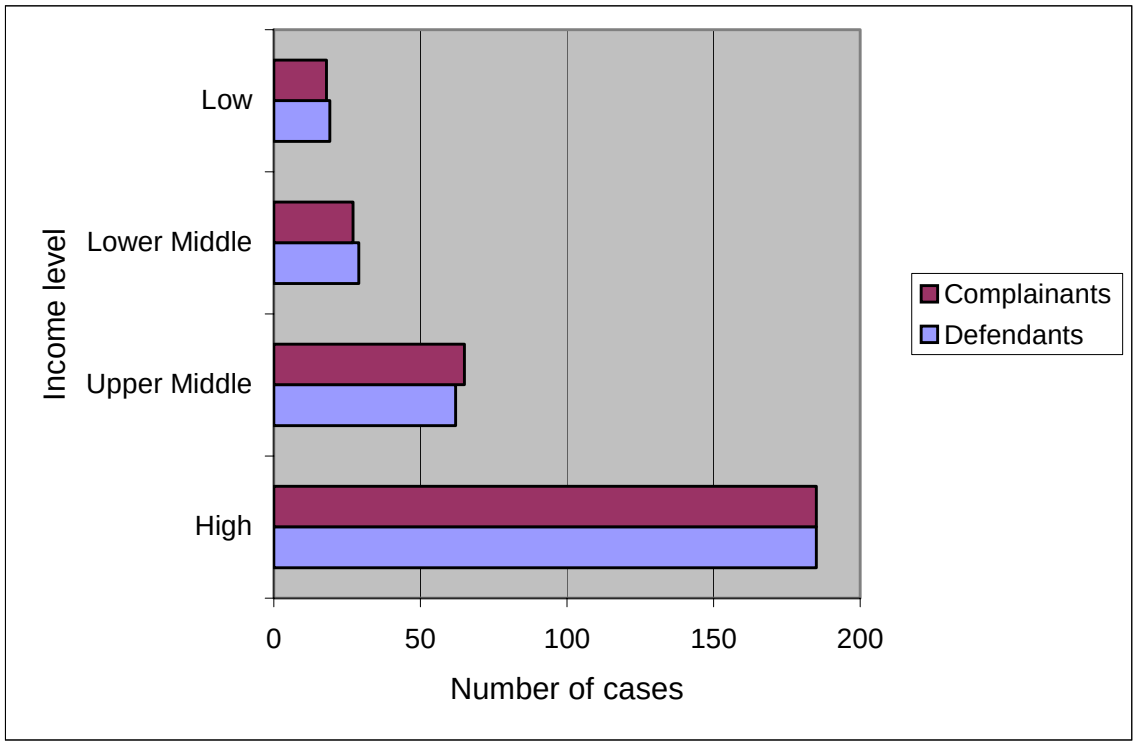

Chart 3.20: Complainants and defendants by income level[90]

[89] See e.g. Jackson (2002), p. 109f, who argues that "some of the smaller countries that are Members of the WTO are finding great comfort in the more rigorous and more rule-oriented dispute settlement procedures that have been introduced by the Uruguay Round text."

[90] Data source: www.worldtradelaw.net. Numbers are based on the period 1995 to 2002. High income: 52 countries; upper middle: 38 countries; lower middle: 52 countries; low: 66 countries (categorisation by the World Bank, April 2003).

Countries of the lower-middle-income category have lodged another 29 complaints. Yet there is an astonishing balance for all income categories as regards the number of complaints lodged by each category and the number lodged against it. In other words, it is possible to reject the hypothesis that WTO dispute settlement is biased in the sense that developed countries complain and the developing world responds.

Another way of showing that the DSU is not biased against the weak is presented in Chart 3.21. High-income countries do not seem to direct their complaints disproportionately against countries with lower income levels: 67 percent of all complaints from high-income countries are targeted against countries in the high-income category. Prominent are, for example, the numerous transatlantic disputes in which the EC and the US have been accusing each other to be in conflict with WTO rules.[91] Only one third of complaints by high-income countries address the many countries with lower income.

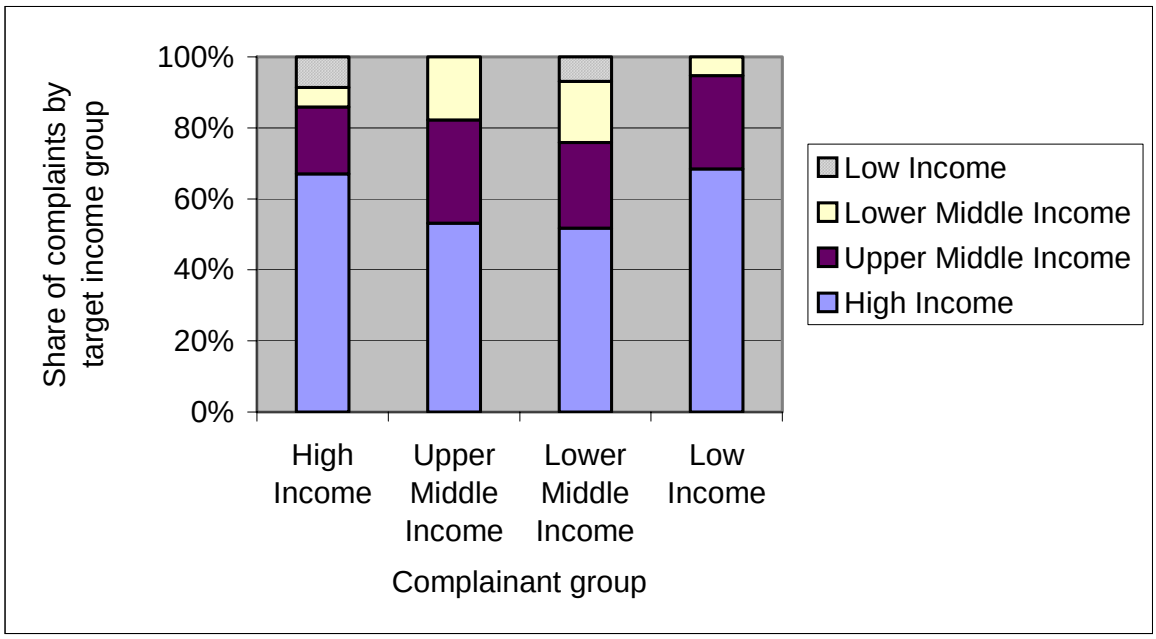

Chart 3.21: Target income group by complainant group[92]

Finally, even more supportive for the claim that the DSU represents a useful tool for the weak is the fact that low-income countries direct 68 percent of their complaints against

[91] A comprehensive reference for transatlantic disputes is the book edited by Petersmann and Pollack (2003).

[92] Data source: www.worldtradelaw.net. Numbers are based on the period 1995 to 2002. High income: 52 countries; upper middle: 38 countries; lower middle: 52 countries; low: 66 countries (categorisation by the World Bank, April 2003).

high-income countries, and that virtually all of their complaints address countries with a higher income level than their own (see again Chart 3.21).[93] The DSU is not a one-way street by which the strong correct the weak, and the weak correct at best themselves. Rather, it is a mechanism that enables complaints by and against countries regardless of their income.

This rosy picture is, however, not the full truth. Looking at the 19 complaints originating in the low-income group, 13 were brought forward by India alone, another two by India together with other countries, one by Pakistan, one by Indonesia, and two by Guatemala in co-operation with other countries. This means that the overwhelming majority of low-income countries has not been an active user of the DSU. On the other hand, of the 18 complaints against low-income countries, 14 were directed against India, two against Nicaragua and two against Pakistan. Therefore, most low-income countries have not at all been in contact with the dispute settlement process, neither as a complainant nor as a defendant. Since it is plausible to assume that low-income countries (1) are regularly confronted by illegal trade barriers abroad and (2) violate WTO rules themselves, two conclusions are warranted. Firstly, low-income countries often do not have the means to bring a case, or they are dissuaded from doing so for some reason. Secondly, the markets of low-income countries are not sufficiently interesting for foreign countries in order to induce the latter to challenge illegal trade policies of the former.

In sum, there is contradicting evidence on the fair balance of the WTO dispute settlement. An influential study on the question of whether the dispute settlement is biased against poor countries was written by Horn, Mavroidis and Nordström (1999). The basic idea behind their work is that the probability of encountering disputable foreign trade measures is proportional to the diversity of a country's exports over products and partners. In the authors' model, countries with a high diversity (which is synonymous with high income) are expected to bring more complaints than less diversified (i.e. poor) countries. The empirical data on WTO dispute settlement support the model quite well. The authors conclude that high-income countries do not target low-income countries disproportionately, nor do low-income countries bring fewer complaints against high-income countries than expected by the model.

[93] The most famous case in this regard is *US – Restrictions on Imports of Cotton and Man-Made Fibre Underwear*, WT/DS24, where Costa Rica successfully challenged US trade barriers.

* * *

After having examined the characteristics of the countries engaged in the WTO dispute settlement process, another question merits attention. It relates to the object of dispute. For the purpose of this study, those disputes are of particular interest that concern the application of lawful flexibility instruments, i.e. antidumping, countervailing duty, and Safeguard Clause action. These instruments are often called "trade remedies". The respective information is useful because it can help to reclassify some cases of temporary protection with regard to the adopted instrument. Before expanding this argument, two data sets are provided (Charts 3.22 and 3.23). Chart 3.22 shows the percentage of disputes between 1995 and 2002 that were about trade remedies.

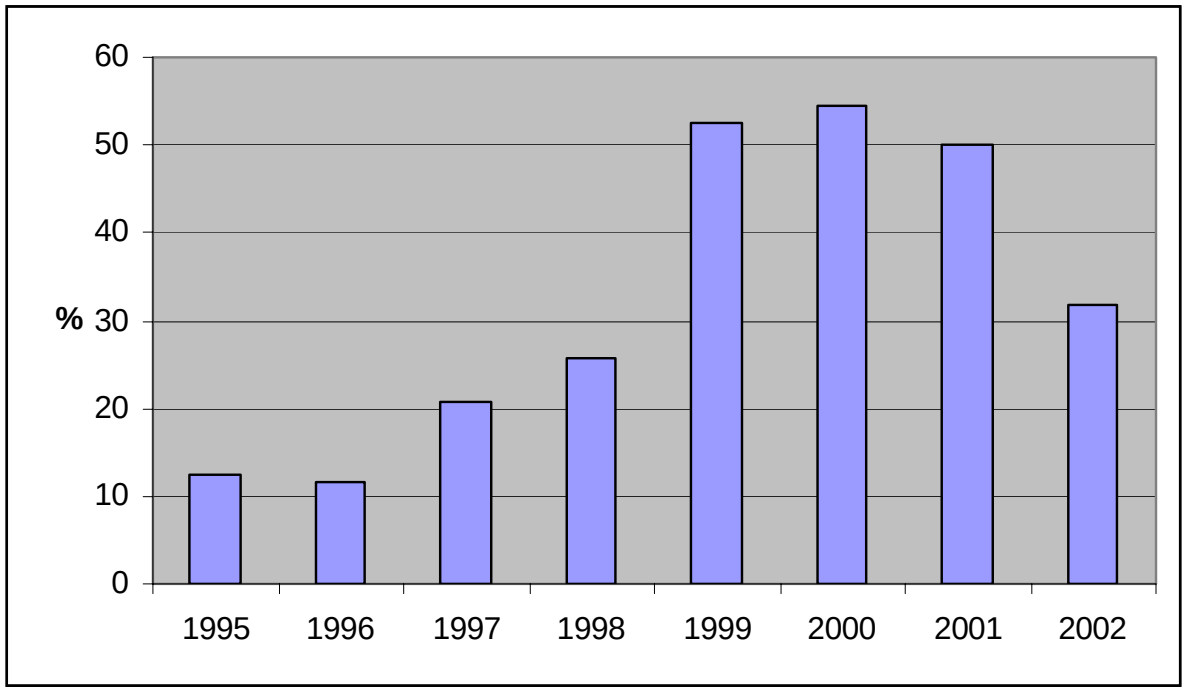

Chart 3.22: Percentage of WTO disputes about trade remedies[94]

Two comments are warranted. Firstly, the percentage of trade remedy disputes is high: WTO dispute settlement is very much about trade remedies.[95] Secondly, there had been a rising trend between 1995 and 2000, and although this trend was interrupted in the

[94] Data source: GAO (2003). The data combine multiple requests for consultation regarding the same measure or national law in one single dispute. For example, the nine consultations requested (from nine WTO members) regarding the steel safeguard measure imposed by the US in March 2002 are counted as only one dispute.

[95] This is confirmed by Hauser (2001).

following two years, the percentage values remained considerably higher than in the early days of WTO dispute settlement. The US was a defendant in 47 percent of these cases, while it was responsible for only 17 percent of worldwide trade remedy measures.[96] This discrepancy is one of the main reasons for considerable critique of the WTO dispute settlement in the US: there are strong concerns that the DSB rulings could severely impair the US ability to use trade remedies.

Charts 3.23 (a), (b), and (c) compare for each trade remedy the annual number of complaints with the number of definitive measures in order to calculate what I call the "complaint ratio". The complaint ratio is the division of complaints by the respective definitive measures. The higher the ratio, the higher the share of definitive measures that should not be categorised as safeguard, antidumping or countervailing duty action, but rather as a violation of WTO rules. If a temporary import restriction were notified as, say, a safeguard measure, but the conditions for its use (as defined in Article XIX GATT and in the Agreement on Safeguards) were not fulfilled, then it should *not* be interpreted as a safeguard measure.

Year:	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Complaints:	0	0	2	2	5	3	4	4
Definitive measures:	0	1	3	4	6	6	8	11
Complaint ratio:	**n/a**	**n/a**	**0.67**	**0.50**	**0.83**	**0.50**	**0.50**	**0.36**

Chart 3.23 (a): Safeguard actions: complaints, measures, and complaint ratio[97]

Year:	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Complaints:	1	3	3	6	8	11	6	6
Definitive measures:	157	224	243	255	355	288	362	276
Complaint ratio:	**0.01**	**0.01**	**0.01**	**0.02**	**0.02**	**0.04**	**0.02**	**0.02**

Chart 3.23 (b): Antidumping: complaints, measures, and complaint ratio[98]

Year:	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
Complaints:	1	1	1	3	1	3	2	2
Definitive measures:	19	5	3	6	14	19	14	14
Complaint ratio:	**0.05**	**0.20**	**0.33**	**0.50**	**0.07**	**0.16**	**0.14**	**0.14**

Chart 3.23 (c): Countervailing duties: complaints, measures, and complaint ratio[99]

[96] See GAO (2003).

[97] Disputes with multiple complaints are counted only once. Data on complaints and definitive measures come from the WTO website and from www.worldtradelaw.net.

[98] Data source: WTO website and www.worldtradelaw.net.

The complaint ratios are not meant to give a definitive conclusion on the numbers of "true" and "false" safeguard (or antidumping or countervailing duty) measures. As argued above, a complaint corresponds to a violation most of the time, but not always. Furthermore, a definitive measure is not necessarily challenged already in the year of initiation, nor does the absence of a complaint be a guarantee that there is no violation. Nonetheless, the complaint ratios show that antidumping measures are mostly in accordance with the rules, while the notified safeguard measures regularly violate them. Countervailing duty actions are somewhere in between. The divergences may be explained by the different levels of prerequisites for the three flexibility instruments (as shown in Chapter 5): while the rules on antidumping are liberal, there are high requirements for a safeguard measure.

* * *

Chart 3.24 is conclusive on the question of what happens to a complaint once it is brought forward. About 30 percent of all complaints since 1995 have reached the panel stage. Some of the remaining 70 percent might still reach it at some future date (some cases are fairly recent), but most of them have been suspended, due to bilateral negotiations that have led (or should lead) to a settlement. Of those panel (or, if appealed: Appellate Body) reports that have been adopted, 61 percent have enabled a settlement of the dispute.[100] 36

[99] The number of complaints only counts those against countervailing duties, not against the Agreement on Subsidies and Countervailing Measures in general. Data from the WTO website.

[100] There is no real notification requirement after a dispute has been settled. According to Article 21:6 DSU, "[t]he DSB shall keep under surveillance the implementation of adopted recommendations or rulings. The issue of implementation of the recommendations or rulings may be raised at the DSB by any Member at any time following their adoption. Unless the DSB decides otherwise, the issue of implementation [...] shall remain on the DSB's agenda until the issue is resolved. [...]" However, the recent proposal for DSU reform by Péter Balás, Chairman of the DSU negotiations in the framework of the Doha Round, includes the following modification: "The Member concerned shall report on the status of implementation of the recommendations and rulings of the DSB at each DSB meeting where any Member may raise any point pertaining thereto. The Member concerned shall start to report under this provision from the midpoint of the length of the reasonable period of time or 6 months after the date of adoption of the recommendations and rulings of the DSB, whichever is the earlier, and continue until the parties to the dispute have mutually agreed that the issue is resolved. [...]" See the annex to Document TN/DS/9, 6 June 2003, *ad* Article 21:6b. Though this wording is a little more binding, it still does not require that a settlement is formally notified. For the information in Chart 3.24, a dispute is deemed to be settled if the complainant has announced implementation and the defendant has not disagreed.

percent are still open, and 3 percent are currently involved in retaliation in the form of suspension of concessions and other obligations.[101]

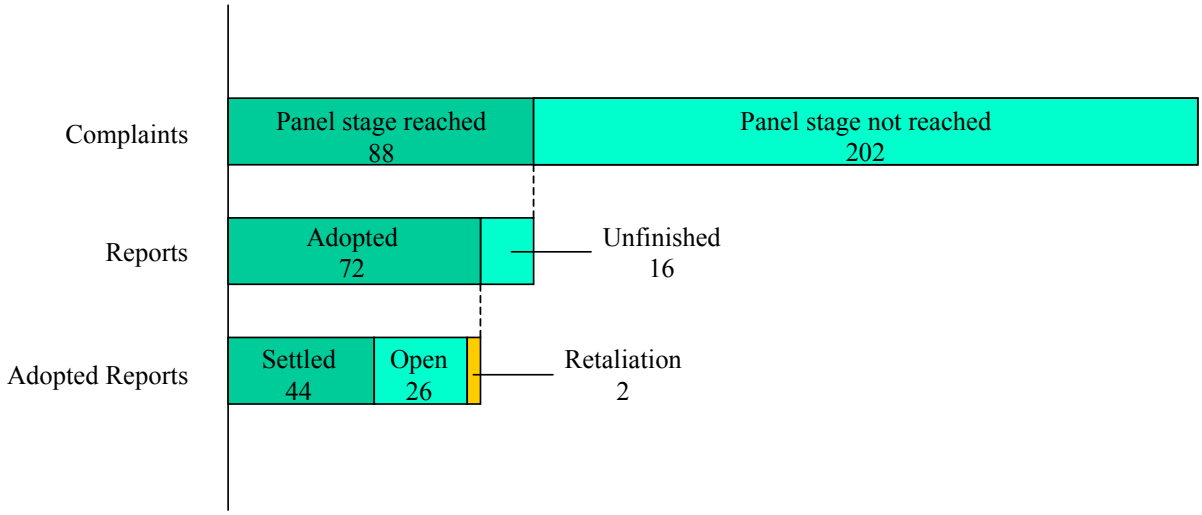

Chart 3.24: State of play of WTO complaints 1995-2002[102]

The fact that reports which have been adopted do not necessarily lead to a mutually acceptable solution is also confirmed by the number of implementation disputes under Article 21:5 DSU.[103] Chart 3.25 shows that they have totalled 18 since 1995. This represents a share of 25 percent of all adopted panel (or Appellate Body) reports.

[101] The US and Canada suspended concessions in response to the failure of the EC to comply with the DSB ruling in *EC – Measures Concerning Meat and Meat Products (Hormones)*, WT/DS26, 48. Retaliation is governed by Article 22 DSU and will be discussed further in the following chapters.

[102] Based on the *Update of WTO Dispute Settlement Cases*, 1 May 2003, WTO Document No. WT/DS/OV/13. The period under observation ended on 29 April 2003, therefore the total number of complaints is higher than reported in Charts 3.17 and 3.19. The figures represent the number of cases.

[103] Article 21:5 DSU reads: "Where there is disagreement as to the existence or consistency with a covered agreement of measures taken to comply with the recommendations and rulings, such dispute shall be decided through recourse to these dispute settlement procedures, including wherever possible resort to the original panel. [...]"

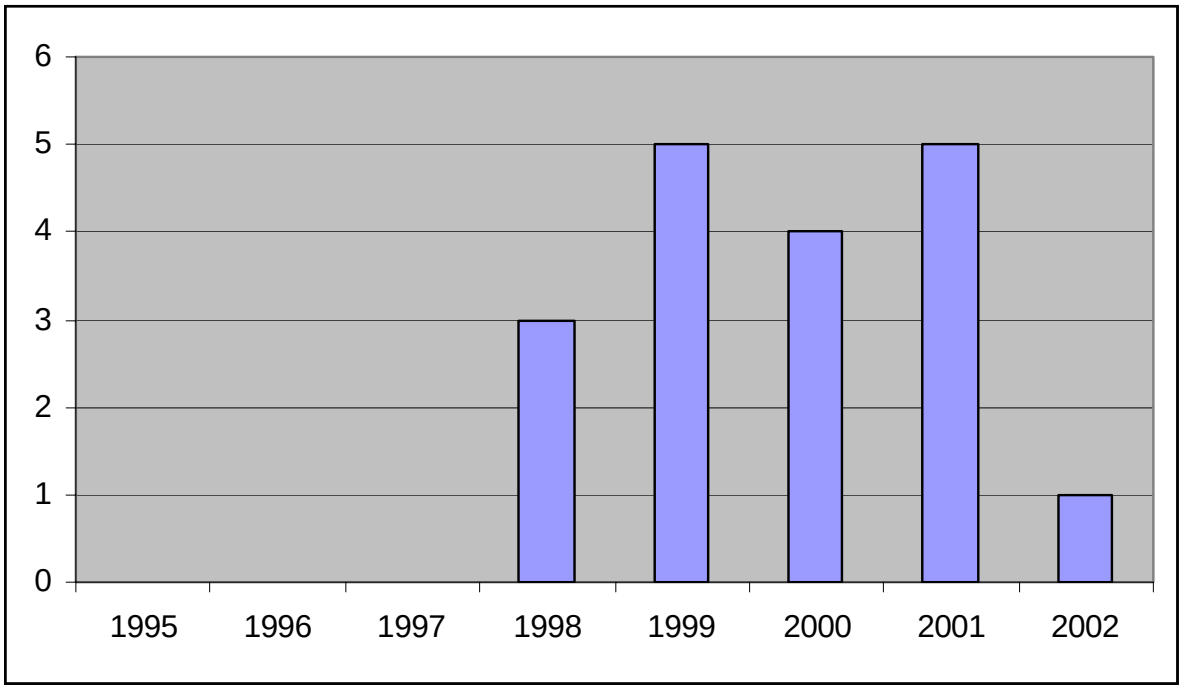

Chart 3.25: Annual number of complaints under Article 21:5 DSU[104]

On the other hand, overall dispute settlement performance does not seem to be bad. Many observers describe it even as "very successful".[105] This judgement depends on the criteria selected for the measurement of success. One criterion is the frequency of retaliation, which has obviously been low. While this could be due to the perceived cost or ineffectiveness of retaliatory action, it may also be caused by a high level of compliance.

The compliance level is actually difficult to determine since the economic outcome of many disputes remains in the dark.[106] Hudec (2002, p. 213) writes nonetheless that "[d]uring the first five years of WTO operation, I have been somewhat surprised by the extent of WTO government efforts to comply." Jackson (2002, p. 110) accedes to this opinion by claiming that "although there are a few notorious examples of non-compliance in relation to some of the completed dispute settlement reports, on the whole there appears to be a very good record of compliance, including compliance by some of the most powerful nations [...]".

[104] Data source: Leitner and Lester (2003).

[105] See Jackson (2000), p. 269, for the reference to these observers. Jackson (2002), p. 109, himself calls the reform of the procedure in the Uruguay Round "extraordinarily successful".

[106] To my knowledge, there is no comprehensive study analysing the actual compliance level in the WTO. This is confirmed by Charnovitz (2003). Zimmermann (2001) argues that defendants are regularly tempted to keep the substance of an initial violation, but to find an arrangement that somehow circumvents WTO rules and is therefore difficult to challenge.

3.5 A comparative assessment

I conclude this chapter with a brief comparative study on the empirical use of the four flexibility instruments. Chart 3.26 shows standardised numbers for the use of the three lawful devices and for complaints under the DSU (again as an approximation for violations).

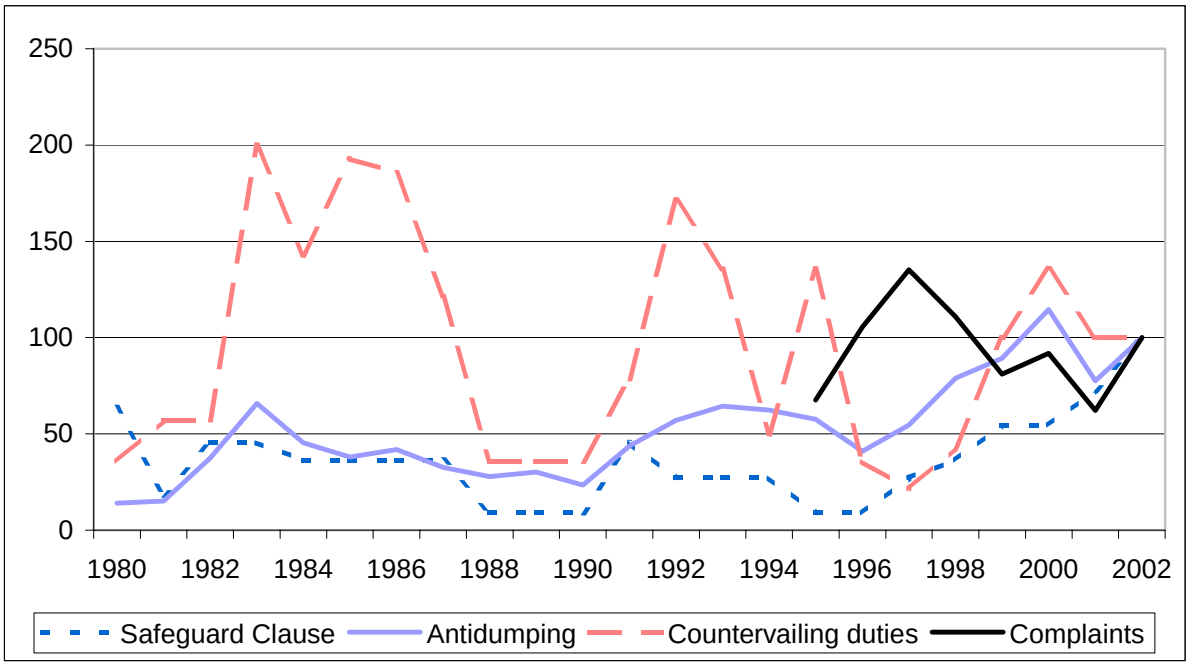

Chart 3.26: Standardised numbers for the annual use of flexibility instruments[107]

While I do not intend to overstrain them, there are parallels in the usage of safeguard measures, antidumping, and countervailing duties over time. The use of trade policy flexibility has a cyclical component. A general low in 1981 is followed by a high until the beginning of the Uruguay Round, after which a sudden low is reached in 1988. After 1990, there is again a strong rise, followed by a low in 1996, just after the end of the Uruguay Round. Since then, a new rise can be observed. Except for the decline between 1998 and 1999, the development in the use of the violation instrument after 1995 is quite synchronous to the development of the three lawful flexibility instruments.

[107] Actual numbers are standardised to a level of 100 in 2002. For Safeguard Clause, antidumping, and countervailing duties, definitive measures are counted.

4 The Political Economy of Flexibility

The empirical data provided in the preceding chapter are not intended to test any particular model of trade policy flexibility, but to give a comprehensive understanding of the prevalence of different instruments. Therefore, it is permissible to present the theoretical foundations of trade policy flexibility *after* the descriptive statistics.

The theoretical underpinning in this chapter abstracts from individual trade policy tools. In other words, trade policy is conceived as a unitary mechanism to achieve well-defined political ends. In recent years, a large body of literature on the political economy of trade policy has emerged. Important aspects of this literature will be discussed here. However, the aim is not to provide a complete survey. Rather, the chapter will establish a sound theoretical basis for understanding the importance of trade policy flexibility in the world trading order.

The chapter has three sections. While the first two sections are a stepwise introduction to the political economy of trade policy, trade policy flexibility is explicitly analysed in the third section. The first section is dedicated to models that describe the equilibrium structure of trade protection in a small country. Their bottom line is that governments respond to organised interests when formulating trade policy decisions. The models differ in the way of how organised interests are transformed into policy outcomes. The seminal contribution of Grossman and Helpman (1994) will receive particular attention.

The second section gives up the small-country assumption and introduces strategic interaction in a two-country setting. Two cases are distinguished. In the first case, governments behave unilaterally, ignoring negative impacts of their actions on political and economic entities in the other country. More interesting for the purposes of this study is the second case: the governments conclude an international trade agreement. The two-country model allows to see what this agreement looks like in the presence of organised interests in both countries.

The main weakness of this model is its failure to make predictions on what happens to the international trade agreement when the values of some underlying variables change over time. The agreement puts a formal restraint on an increase in protection, but it is

implausible to assume that this restraint is carved out of stone. In order to tackle this problem, one has to go beyond a static description of the protection structure scheduled in an international trade agreement. It is necessary to treat such an agreement as an incomplete contract, prompting the desire for *ex-post* modification.

According to Battigalli and Maggi (2002), there are two distinct forms of incomplete contracting: "rigidity" and "discretion". An agreement is characterised by rigidity if the terms of the contract (i.e. the concessions made by the parties) are not made sufficiently dependent on the future state of the world. Discretion, on the other hand, is given whenever an agreement does not specify the concessions with precision. In both cases, expectations of the contracting parties are regularly disappointed after the conclusion of an agreement.

A formal answer to the rigidity problem is trade policy flexibility, which is the theoretical focus of the third section in this chapter.[108] There, the structure of optimal protection from a government perspective is susceptible to changes in different variables. The diversity of these variables and the uncertainty characterising their development make it impossible to write an international trade agreement that makes all actions contingent on the evolvement of these variables. In an attempt to overcome this rigidity, governments endow the international trade agreement with mechanisms that maintain their trade policy flexibility. Adjusting a model by Ethier (2002), I will investigate the characteristics of such an agreement.

4.1 The structure of trade protection in a small country

4.1.1 The potential advantages of trade intervention for redistributive purposes

In a small country that is unable to influence its terms of trade, import barriers serve domestic redistributive purposes: they create rents for import-competing sectors at the public expense. However, why are these redistributive goals not achieved by policies other than trade intervention?

At first glance, import restrictions represent a tool for redistribution that is clearly inferior to production subsidies from an economic efficiency perspective: while the latter cause

[108] A possible answer to the discretion problem is third-party arbitration. Discretion is not the object of this study, since it does not include a deviation from initial concessions but an interpretation of them.

distortions on the production side of the economy only, the former are associated with distortions on both the production and the consumption side.[109] However, as Rodrik (1986) shows, such a comparison is too simple. He presents a model wherein tariffs and, alternatively, production subsidies are endogenously determined by interest-group lobbying. A tariff has the nature of a public good from the perspective of an individual firm in the import-competing industry: firm-specific benefits occur regardless of whether the firm contributes to lobbying activities or not. In other words, there is an incentive for free-riding. As a consequence, these activities are underprovided from the perspective of the industry as a whole. In seeking production subsidies, in contrast, there need not be a public-good element: an individual firm could get firm-specific subsidies, the benefits of which are entirely private. Rodrik argues that a rational citizenry might find it beneficial to pre-commit the government to provide tariff protection only. This would maintain the free-rider behaviour among individual firms, and the endogenously resulting distortion level could finally be lower than in a regime of production subsidies. In conclusion, tariffs would be preferable to subsidies based on social welfare considerations.

Another way of justifying trade intervention for the aim of domestic redistribution is provided by Feenstra and Lewis (1991). They compare tariffs with an income transfer that would not result in any market distortion. Suppose that a firm initially sells quantity x_0 at price p_0. Suppose next that the price drops to $p_1 < p_0$. An income transfer in the amount of $(p_0 - p_1)x_0$ would exactly maintain the firm's original income if it decided to sell the original quantity. Furthermore, the transfer would even make it better off if it chose to adjust the quantity in response to the price change. Both consumption and production distortions could be avoided.[110] The problem is, however, that the government might not be able to observe x_0. In this case of incomplete information, a tariff could become an efficient device if the government wanted to make sure that no one loses after the drop of p. A tariff in the amount of $p_0 - p_1$ would fully compensate every firm for the price drop, regardless of the original sales volume. Therefore, while being inefficient under perfect information, a tariff could be superior under incomplete information.

Both approaches discussed thus far merit attention. However, there are political-economy explanations for trade intervention that are more straightforward. In contrast to production

[109] See Corden (1997) for an analytical treatment.

subsidies and income transfers, tariffs do not increase public expenditure (but possibly provide public revenue instead). This contributes to their political attractiveness. As argued in Chapter 2, subsidies have to be financed by taxpayers. Taxes are unpopular. Furthermore, the distribution of financial means in the form of subsidies shows up in the public accounts, causing an appearance of favouritism.

It could be argued that a rational citizenry should be aware of the fact that tariffs are a form of hidden taxation. However, considerable effort is needed to detect and calculate the actual burden for consumers: the transparency of tariffs is definitely confined. Furthermore, some advanced understanding of economics is needed in order to realise that import restrictions exclusively raise the income of the import-competing industry.

4.1.2 The structure of protection: a typology of models

The prevalent models for explaining the structure of trade protection can be categorised according to characteristics of the political process: the government either is in charge of trade policy (categories 1 and 2) or not (category 3), and it either has already been elected (category 1) or is amidst an electoral campaign (category 2).[111]

The first category has an incumbent government seeking to maximise political support. This effort could be motivated by the prospect of future elections, but these elections do not show up in the models. Findlay and Wellisz (1982) pioneered the so-called tariff-function approach in which the tariff level is the outcome of rivalry between a pro-trade and a protectionist lobby. Two sectors produce with labour and a sector-specific factor. Each one is represented by a lobby. The lobbying activity uses up labour resources in the amount of L_1 (made available by the import-competing sector) and L_2 (provided by the other sector). The resulting tariff t in the import-competing sector is a *Nash* equilibrium and can be expressed as

$$(4.1) \quad t = t(L_1, L_2) \text{ with } \frac{\partial t}{\partial L_1} > 0 \text{ and } \frac{\partial t}{\partial L_2} < 0 .$$

[110] It is implicitly assumed that the taxes used to finance the income transfer can be collected without causing distortions.

[111] A somewhat different categorisation can be found in Rodrik (1995). See also Grossman and Helpman (2002), Magee (1994), Magee, Brock and Young (1989), and Hillman (1989).

In equilibrium, both lobbies spend resources up to the amount where the marginal cost of these resources equals the marginal benefit in the form of additional sectoral welfare. Findlay and Wellisz show that, all else equal, the emergence of a positive tariff level depends on the marginal rate of substitution between pro-trade and protectionist spending: trade protection occurs if a unit spent by the protectionist lobby increases the tariff by more than the latter declines in response to an additional unit spent by the pro-trade lobby.

In the model of Findlay and Wellisz, the government derives some utility from lobbying activities, otherwise it would not respond by changing the tariff level. However, the functional form of this utility remains in the dark. Hillman (1989) introduces an explicit government objective function *G* with two components. The first component is the political support from organised interests. The second one is social welfare. Hillman, arguing again in a specific-factor setting, represents the profit function of the specific factor in the import-competing sector by π. The profit function is assumed to be a proxy for the sector's political support for the government. A tariff-induced increase in *p*, which is the domestic price of its output, raises the profit of the import-competing sector. However, social welfare is negatively correlated with the level of price distortion *d*. Hence, the government objective function is

$$(4.2) \quad G = G[\pi(p - p^*), d(p - p^*)] \text{ with } \frac{\partial G}{\partial \pi} > 0 \text{ and } \frac{\partial G}{\partial d} < 0,$$

and p^* representing the world price. Diminishing marginal political support for an increase in protection implies

$$(4.3) \quad \frac{\partial^2 G}{\partial \pi^2} < 0,$$

while increasing marginal antagonism with price distortion on the part of society is denoted by

$$(4.4) \quad \frac{\partial^2 G}{\partial d^2} < 0.$$

The optimal tariff-inclusive price *p* can be derived from the following utility-maximising calculus:

$$(4.5)\quad \frac{\partial G}{\partial p} = \frac{\partial G}{\partial \pi} \times \frac{\partial \pi}{\partial p} + \frac{\partial G}{\partial d} \times \frac{\partial d}{\partial p} \stackrel{!}{=} 0 .$$

What happens to p when the exogenously-given p^* decreases? If the tariff rate remained unchanged, p would decrease in line with p^*, causing a contraction of the import-competing sector. On the other hand, since p is determined under political-economy considerations, a tariff increase could offset the decline in the world price, and the sector might not contract at all. Hillman shows that the truth is more complex: while the model necessarily predicts a decline in p in response to a lower p^*, the level of protection (i.e. the tariff rate) may increase or decrease. In conclusion, there is no full compensation for the income loss of the sector. Thus, the sector will shrink even in view of an increased protection level.

* * *

The structure of trade protection is not necessarily determined only *after* a government has been elected. Rather, it could be the topic of an electoral campaign. Opposing candidates for government announce different trade policy programs that they would implement in the case of election. This political competition is the subject of the second category of models discussed in this subsection.

Magee, Brock and Young (1989) introduce a two-stage game, with two opposing candidates presenting their trade policies (import tariff or export subsidy) in the first stage. One candidate is assumed to be protectionist, the other one pro-trade. In the second stage of the game, lobbies make campaign contributions to either of the two candidates. In other words, the candidates are *Stackelberg* leaders over the lobbies.[112] Anticipating the equilibrium of stage two, the candidates play *Nash* strategies in determining their policy announcements in the first stage.

Formally, Magee, Brock and Young apply a *Heckscher-Ohlin* model with two sectors (X and Y) and two factors of production (capital K and labour L). The economy is capital-abundant, and X is the capital-intensive good. Hence, the country has a comparative advantage in X. Each factor of production is represented by a lobby. The protectionist candidate is supported by the L-lobby, and the pro-trade candidate receives contributions

[112] For an introduction to the *Stackelberg* model in game theory see Varian (1992), p. 295ff.

from the *K*-lobby. Similar to Findlay and Wellisz, lobbying activities use up a fraction of the production resources, denoted k ($< K$) and ℓ ($< L$).

Each candidate attempts to maximise his election probability. The pro-trade candidate maximises[113]

$$(4.6)\quad \underset{s_x}{\text{Max}}\ q = q\left(k, \ell, s_x, t_y\right) \text{ with } \frac{\partial q}{\partial k} > 0, \quad \frac{\partial q}{\partial \ell} < 0, \quad \frac{\partial q}{\partial s_x} < 0, \quad \frac{\partial q}{\partial t_y} > 0$$

where s_x is the subsidy for the export sector X and t_y is the tariff on imports of Y. If the pro-trade candidate proposes an increase in s_x, expected social welfare decreases on distortion grounds. This has a negative impact on the election probability q. However, an increase in s_x also induces more political contributions k from the *K*-lobby, which raises q. On the other hand, q decreases with the political contributions ℓ received by the protectionist candidate, but increases with the tariff proposed by the latter, since t_y reduces expected social welfare.

In equilibrium, each candidate announces his level of trade intervention in the respective sector, anticipating the announcement of the rival candidate *and* the level of contributions offered by the lobbies. How do the lobbies determine their contributions? Consider the *K*-lobby's objective function. It maximises its expected income less the cost of running the lobbying activity:

$$(4.7)\quad \underset{k}{\text{Max}}\ \left(q r_K + (1-q) r_L\right) K - k$$

with r_K and r_L representing capital returns when the pro-trade or, alternatively, the protectionist candidate is in power. For the *L*-lobby, ℓ is implicitly determined by

$$(4.8)\quad \underset{\ell}{\text{Max}}\left(q w_K + (1-q) w_L\right) L - \ell$$

with the labour returns under the two scenarios being given by w_K and w_L.

* * *

The third category of political economy models presented here assumes that trade policy is not determined by the government, but by direct-democratic majority voting. Mayer

(1984) analyses potential determinants of actual tariffs, such as the factor-ownership distribution or participation rights. Breaking with the standard assumption that every individual owns one factor of production only,[114] Mayer allows everyone to hold a portfolio of them. Furthermore, factor-ownership shares differ among people. Consequently, the number of factor owners voting for or against a given tariff change will no longer be fixed, but will depend on the original tariff rate. Each factor owner has an optimal tariff rate, the value of which is exclusively related to his factor portfolio. If there were no voting costs, the median factor owner's choice would become the actual tariff rate.

Participation rights have a decisive effect on the relevant factor-ownership distribution. Major restrictions resulting from age, residency, or citizenship prevent the factor-ownership distribution of voters from corresponding to that of the entire population. Mayer argues that actual restrictions primarily affect "capital poor" people (e.g. the youth and foreigners). Accordingly, voters are more likely to protect the interests of capital owners. It follows that modified voting rules affect the identity of the median voter and thereby the trade policy outcome. A dismantling of participation restrictions, as gradually observed in the past, is expected to be associated with declining tariffs on capital-intensive products and rising tariffs on labour-intensive imports.

While this line of reasoning brings in some new aspects on the formation of trade policy, it has a major flaw: as an empirical matter of fact, trade policy is not determined by direct-democratic decision-making in most instances. Even in Switzerland, a country that is famous for its direct-democratic tradition, voters determine only rough guidelines on the cross-border exchange of goods.

4.1.3 The Grossman-Helpman model

The seminal contribution by Grossman and Helpman (1994), which provides "the current leading political economy model"[115] in international trade, belongs to the first category of trade protection models in accordance with the preceding typology: an incumbent

[113] The election probability of the protectionist candidate is given by 1 – q.
[114] Baldwin (1982) observes that under the standard assumption, majority voting could completely eliminate trade of a capital-abundant country if there were more workers than capital owners. This suggests that the assumption has limited appeal in explaining actual tariff structures.
[115] Limão and Panagariya (2002), p. 1.

government attempts to maximise its political support. The goal of re-election may be present at the back of its mind, but the electoral campaign – and the position of potential rivals – is not explicitly formulated.

It has just been argued that the majority-voting model has limited appeal due to its lack of realism. However, what drives the decision in favour of the political-support approach, at the expense of political-competition models? Grossman and Helpman (G-H) consider the latter most useful for explaining the "broader contours" of trade policy, such as the commitment to a liberal or interventionist style, the preference for capital or labour, and the bias towards the rich or the poor.[116] For the "finer details" of trade intervention, e.g. the extent to which different industries are favoured, the political-support approach seems to be more appropriate.

Let me start by introducing the main assumptions of the G-H model. G-H look at a small, competitive economy facing given world prices. Such an economy cannot influence its terms of trade: free trade maximises social welfare. There is a numeraire good, produced with labour alone, and n additional products, each produced with labour and a factor specific to the respective sector. In contrast to Mayer (1984), an individual can own at most one type of specific input, but is always a labourer as well. The ownership determines the individual's sectoral affiliation and is non-tradable. If no specific input is owned, the individual is necessarily employed in the numeraire-good sector.

In an exogenous number F ($< n$) of sectors, the owners of the specific input have been able to organise themselves and to form a lobby group. G-H do not model the process of lobby formation and the inherent free-rider problem,[117] but simply assume that some sectors succeed in their respective attempt, while others do not. Each of these F lobbies confronts the incumbent government with a "contribution schedule", taking the schedules of other lobbies as given. This schedule maps every government policy vector (consisting of import tariffs and export subsidies on the n non-numeraire goods) into a level of political support. In other words, before the government decides on a particular policy vector, it already knows how much political support it will get for it from the lobbies. Political contributions can consist, for example, of financial means used for electoral campaigns or for signalling the government's ability as a fund-raiser.

[116] See p. 834.

G-H analyse both stages of this two-stage non-co-operative game. The outcome of the first one is a *Nash* equilibrium in contribution schedules presented by the lobbies. Based on this equilibrium, the government determines in stage two the structure of protection.[118] Since it is this structure that draws my attention in the G-H model, I am only interested in the second stage of the game. Therefore, I characterise the emerging structure of protection while taking the contribution schedules of stage one as *given*.

Individuals in the economy differ exclusively in their factor endowments. As mentioned, each individual owns one unit of labour and at most one type of specific factor. Its quasi-linear utility function[119] is given by

$$(4.9) \quad U = x_0 + \sum_{i=1}^{n} u_i(x_i)$$

where x_0 denotes consumption of the numeraire good, and x_i is the consumption of good i. The subutility functions u_i are differentiable, increasing and concave. The individual is faced with a budget restriction E and confronts the following *Lagrange* maximisation problem:

$$(4.10) \quad \underset{x_0, x_1}{\text{Max}}\, L = U + \lambda(E - p_0 x_0 - \sum_{i=1}^{n} p_i x_i)$$

with p_0 and p_i denoting the domestic prices of the numeraire good and good i, respectively. Since the price of the numeraire good is 1,

$$(4.11) \quad \frac{\partial L}{\partial x_0} = 1 - \lambda \overset{!}{=} 0$$

and

$$(4.12) \quad \frac{\partial L}{\partial x_i} = \frac{\partial u_i(x_i)}{\partial x_i} - \lambda p_i \overset{!}{=} 0 .$$

The demand function for good i is therefore

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[117] See Stigler (1974), Olson (1965) and the model of Rodrik (1986) introduced in Subsection 4.1.1 above.
[118] Note the contrast to Magee, Brock and Young (1989): their sequence has the electoral candidates moving first, while the lobbies act in the second stage.
[119] For a general treatment of quasi-linear utility functions see Varian (1992), p. 164ff.

$$(4.13)\quad d_i(p_i) = x_i = \left[\frac{\partial u_i(x_i)}{\partial x_i}\right]^{-1},$$

which is the inverse of the first derivative of the subutility function. Indirect utility of the individual is

$$(4.14)\quad V = E + \sum_{i=1}^{n} s_i(p_i)$$

with

$$(4.15)\quad s_i(p_i) = u_i[d_i(p_i)] - p_i d_i(p_i)$$

being the consumer surplus derived from the non-numeraire good *i*.

Looking at the production side, remember that the numeraire good is manufactured from labour alone. Assuming constant returns to scale and an input-output coefficient equal to 1, the wage rate equals 1 in equilibrium. With this fixed wage rate, the return to the specific factor *i* depends only on p_i and is denoted by $\pi_i(p_i)$. Domestic supply is therefore

$$(4.16)\quad X_i(p_i) = \frac{\partial \pi_i}{\partial p_i},$$

using *Hotelling*'s lemma.[120] In formulating its trade policy, the government drives a wedge between domestic and world prices, the latter denoted by p_i^*:

$$(4.17)\quad p_i = p_i^* + t_i \ .$$

If the good *i* is imported, $t_i > 0$ represents a specific import tariff.[121] If *i* is an export good, then $t_i > 0$ is an export subsidy. Domestic prices below world prices correspond to import subsidy and export tax, respectively. Any government revenue surplus is distributed equally to all individuals. A deficit is financed by lump-sum taxation. Therefore, social welfare can be expressed as

$$(4.18)\quad W = \omega + \sum_{i=1}^{n} (\pi_i + t_i M_i + s_i)$$

[120] *Hotelling*'s lemma is defined in Varian (1992), p. 43.
[121] A specific import tariff is a tariff based on product units, and not on product value.

where ω represents total labour income and where

(4.19) $M_i = d(p_i) - X_i(p_i)$

is the import quantity of good *i* (or, if negative, the export quantity). Defining α_i as the fraction of individuals owning the specific factor *i*, lobby *i*'s aggregate welfare is

(4.20) $$W_i = \pi_i + \alpha_i \left[\omega + \sum_{j=1}^{n} (t_j M_j + s_j) \right].$$

The objective function of lobby *i* is given by

(4.21) $W_i - C_i$,

where C_i is its contribution schedule. The government objective function accordingly is

(4.22) $$G = \beta W + (1-\beta) \sum_{i=1}^{n} C_i$$

with $\beta \in [0,1]$ representing the weight that the government attaches to social welfare, relative to political contributions. The higher the value of β, the more benevolent is the government. This is in strong resemblance to Hillman (1989), although G-H translate Hillman's sectoral profit function into a contribution schedule of the respective lobby.

In order to describe the emerging structure of protection, G-H note that the interaction between lobbies and the government has the characteristics of a common-agency problem: several principals attempt to induce a single agent to take an action that is costly for the agent to perform. The government serves as agent for the special interest groups, while incurring the political burden for a deviation from free trade in the form of reduced social welfare. The technical solution kit of G-H for this problem is taken from Bernheim and Whinston (1986), who have characterised the equilibrium for a class of such problems. Here, however, this approach is not followed due to its complexity. Instead, a *Nash* bargaining game is employed that gives rise to the same trade policy outcome.[122]

[122] See Goldberg and Maggi (1999) or Ethier (2003).

At the *Nash* bargaining solution, the trade policy vector is chosen by maximising the joint surplus of the government and all lobbies.[123] This surplus is

$$(4.23)\quad \Omega = \beta W + (1-\beta)\sum_{i\in F} W_i \ .$$

Using (4.18) and (4.20), one obtains

$$(4.24)\quad \begin{aligned}\Omega &= \beta\omega + \beta\sum_{i=1}^{n}(\pi_i + t_i M_i + s_i) + (1-\beta)\sum_{j\in F}\left[\pi_j + \alpha_j\left(\omega + \sum_{i=1}^{n}(t_i M_i + s_i)\right)\right] \\ &= \beta\omega + (1-\beta)\alpha_F\omega + \sum_{i=1}^{n}\left[\beta + (1-\beta)I_i\right]\pi_i + \sum_{i=1}^{n}\left[\beta + (1-\beta)\alpha_F\right](t_i M_i + s_i)\end{aligned}$$

with

$$(4.25)\quad \alpha_F = \sum_{i\in F}\alpha_i$$

representing the share of individuals owning a specific factor where the respective sector has been able to get organised. I_i is a dummy variable that is 1 if $i \in F$ and otherwise 0. The trade policy outcome t_i for industry i is derived from

$$(4.26)\quad \frac{\partial\Omega}{\partial t_i} = \frac{\partial\Omega}{\partial p_i} = \left[\beta + (1-\beta)I_i\right]\frac{\partial\pi_i}{\partial p_i} + \left[\beta + (1-\beta)\alpha_F\right]\left(t_i\frac{\partial M_i}{\partial p_i} + M_i - d_i\right) \overset{!}{=} 0\ ,$$

which yields

$$(4.27)\quad t_i = \frac{I_i - \alpha_F}{\dfrac{\beta}{1-\beta} + \alpha_F} \times \frac{X_i}{-\dfrac{\partial M_i}{\partial p_i}}\ .$$

With

$$(4.28)\quad \tau_i = \frac{p_i - p_i^*}{p_i^*} = \frac{t_i}{p_i^*},$$

one gets in terms of import elasticity and (inverse of the) import-penetration ratio

[123] One way to think about the joint surplus is a situation in which the welfare of all interest groups is fully extracted by the government through their transfers, i.e. $C_i = W_i$ for all $i \in F$.

(4.29) $$\frac{\tau_i}{1+\tau_i} = \frac{t_i}{p_i} = \frac{I_i - \alpha_F}{\frac{\beta}{1-\beta} + \alpha_F} \times \frac{z_i}{e_i}$$

where

(4.30) $z_i = X_i/M_i$

is the equilibrium ratio of domestic output to imports (or exports, if negative), and

(4.31) $$e_i = -\frac{\partial M_i}{\partial p_i} \times \frac{p_i}{M_i}$$

is the elasticity of import demand (or export supply, if negative). Equation (4.29) should be interpreted as follows:

a) Sectors with a high import demand elasticity (or high export supply elasticity in absolute terms) exhibit smaller *ad valorem* deviations from free trade *ceteris paribus*. This is not surprising as long as the government is interested in social welfare, i.e. if $\beta > 0$: since a high elasticity corresponds to a high dead-weight loss of trade intervention, the government prefers to raise contributions from sectors in which such losses are small. However, even if $\beta = 0$, the relationship holds: since all lobbies outside of sector *i* share in the cost of protection as members of society, they will bid more to avoid the protection of sector *i* if the social welfare loss of this protection is high.

b) All sectors represented by lobbies are protected by import tariffs or enjoy an export subsidy.[124] However, import subsidies and export taxes are applied to all non-organised sectors.[125] This underlines the power of organised interests: they succeed in raising the domestic price of their own products, while at the same time obtaining a lower price for all other products.

c) For organised sectors, the level of protection decreases with import penetration, given by $1/z$: in sectors with large domestic output X_i, specific factor owners have much to gain from a domestic price increase, which translates into high

[124] This is because the first term on the right side of equation (4.29) is positive, while z_i and e_i are both positive in the case of an import product and both negative in the case of an export product.

contributions. On the other hand, the economy as a whole has less to lose from protection when M_i is low: production distortions are small. For sectors without lobby, the relationship between protection and import penetration is positive: the higher the latter, the lower are import subsidies and export taxes.

d) The higher the weight β that the government places on social welfare, the lower is the *ad valorem* deviation from free trade. If β is close to 1, there is almost free trade. But even if $\beta = 0$, deviations from free trade do not get out of control as long as the share α_F of individuals represented by lobbies is not too small: as argued under a), lobbies themselves do not have an interest in distortions growing too large and will therefore bid against excessive protectionism.

e) As the share of individuals α_F increases, equilibrium rates of protection for organised industries decline. If all individuals had some specific factor and were organised ($\alpha_F = 1$), there would be no trade intervention any more. In this case, the joint surplus of the lobbies coincides with social welfare, and hence free trade is the optimum. Individual lobbies neutralise each other.

The attractiveness of the G-H model is enhanced by the fact that it has been thoroughly empirically tested by Goldberg and Maggi (1999).[126] Their main message is: in spite of the common knowledge that empirical tests of strict versions of trade models traditionally yield weak results for the theory under investigation,[127] the G-H model is not inconsistent with the Goldberg-Maggi data. While the authors cannot provide a complete empirical support for the model, the absence of inconsistency is remarkable.

The findings of Goldberg and Maggi confirm the prediction of the model that the relationship between import penetration and protection is positive for non-organised sectors. The negative relationship for organised sectors is weakly supported.[128] As regards the weight β that the government attaches to social welfare, the authors find that benevolence figures prominently in the government's objective function: their parameter

[125] This is because the first term on the right side of equation (4.29) is negative if $I_i = 0$.
[126] Further empirical support comes from Gawande and Bandyopadhyay (2000). Similar to Goldberg and Maggi (1999), they employ US data.
[127] The most prominent example is the *Heckscher-Ohlin* model. For an overview of empirical tests of this model, see Krugman and Obstfeld (1997), p. 82-6.

estimate for β is always high (around 0.98), with a 95-percent confidence interval of [0.97,0.99]. I will refer to this result in Chapter 6 again. On the other hand, Goldberg and Maggi are able to reject the hypothesis that the government is a pure social welfare maximiser (i.e. that β = 1).

A last point that is worthwhile to mention concerns variables that, in accordance with the G-H model, should *not* influence the protection structure. Goldberg and Maggi test if an alternative specification that includes additional regressors would improve the model. They use regressors such as unemployment in a sector, growth, or industry concentration. It turns out that, with the exception of some unemployment measures, no variable is able to improve the predictive power of the original G-H model.[129]

4.2 Strategic interaction between governments

4.2.1 The non-co-operative case

If the small-country assumption were relaxed, but it were still assumed that governments behave unilaterally (ignoring the negative impact of their decisions on foreign countries), the structure of trade protection would change only slightly. Based on the model introduced above, Grossman and Helpman (1995) derive the *Nash*-equilibrium trade policy in a two-country setting. Again, domestic and foreign lobbies move in a first step and present their contribution schedules, while governments respond with a trade policy vector in the second stage of the game. The equilibrium response of the domestic government to the expected foreign government's policy is[130]

$$(4.32)\quad t_i = \frac{I_i - \alpha_F}{\frac{\beta}{1-\beta} + \alpha_F} \times \frac{X_i}{-\frac{\partial M_i}{\partial p_i}} - \frac{1}{e_i^f} p_i^* \ ,$$

[128] This prediction is, however, not confirmed by earlier empirical work based on related models. See, among others, Lee and Swagel (1996), Trefler (1993), or Leamer (1988).

[129] More success in finding variables that improve the predictive power of the G-H model is claimed by Esfahani (2002). He observes that protection is regularly directed towards industries with unskilled workers and towards smaller firms with low capital intensity. This is puzzling, since these entities presumably have high costs of political organisation. A common characteristic of these entities is, however, that they face serious constraints in capital and insurance markets. Esfahani argues that governments deal with these market imperfections by affording trade protection. Extensions of the G-H model that incorporate these capital and insurance constraints have an improved predictive power.

[130] The foreign trade policy can be deduced by analogy.

where

$$(4.33)\quad e_i^f = -\frac{\partial M_i^f}{\partial p_i^f} \times \frac{p_i^f}{M_i^f}$$

is the foreign elasticity of import demand (or export supply, if negative). Note that the world price p^* is not identical with the foreign price p^f, since the foreign country imposes trade taxes or subsidies as well. The first component on the right side of equation (4.32) has the same form as in the equilibrium with a small economy facing a fixed world price. The second component, in contrast, represents the terms-of-trade considerations of a large country.

What are the precise implications of these considerations when the government is influenced by organised interests? Consider an organised domestic import-competing industry i, i.e. $e_i^f < 0$, since the foreign country is an exporter in i. Here, the terms-of-trade considerations assist the lobbying effort of the industry: all else equal, t_i is higher than in the small-country case. The amplification of the lobbying effort also happens in the case of a non-organised export industry j, where $e_j^f > 0$. The export tax (represented by the absolute value of t_j) is higher than in the absence of terms-of-trade considerations, since the government's desire to drive up the export price coincides with the desire of organised lobbies that want the domestic price of j to decrease.

In the case of a non-organised import-competing sector or an organised export sector, however, the terms-of-trade considerations can lead to a replacement of trade policy instruments. Depending on the importance of these considerations, the non-organised import-competing sector could get an import tariff: while the government has no interest in protecting non-organised interests *per se* because there is no prospect of political contributions, a tariff-induced terms-of-trade improvement raises social welfare. In analogy, the organised export sector could be faced with an export tax, *despite* its lobbying effort. According to equation (4.32), this is all the more probable the more inelastic the foreign import demand, given by $e_i^f > 0$. It is interesting to note that the terms-of-trade considerations could lead to an export tax even if the government paid no attention to social welfare (i.e. $\beta = 0$). The reason is simple: the lobbies of other sectors share as members of society in the terms-of-trade gains of such a tax and are therefore ready to bid for it.

4.2.2 The co-operative case

What happens if governments enter into negotiations with the aim of concluding an international trade agreement? Such negotiations could be expected if governments recognised that they impose avoidable political costs on each other. Grossman and Helpman (1995) derive the properties of an international trade agreement between two countries, which is efficient in the sense that the utility pursuant to equation (4.22) of one government cannot be raised without lowering the utility of the foreign counterpart. Once more, it is assumed that the organised interests in the two countries set their contribution schedules non-co-operatively in the first stage of the game. However, in the second stage, the two governments choose their trade policy vectors *co-operatively*. The following equation implicitly determines the equilibrium trade policies of the two countries for the organised industry *i*:

$$(4.34)\quad \tau_i - \tau_i^f = \frac{I_i - \alpha_F}{\frac{\beta}{1-\beta} + \alpha_F} \times \frac{X_i}{-\frac{\partial M_i}{\partial p_i} p_i^*} - \frac{I_i^f - \alpha_F^f}{\frac{\beta^f}{1-\beta^f} + \alpha_F{}^f} \times \frac{X_i^f}{-\frac{\partial M_i^f}{\partial p_i^f} p_i^*} \quad .$$

On first inspection, the equation only provides the *ratio* of the two countries' trade policies. However, since one of the countries is the exporter while the other one is necessarily the importer of good *i*, p_i and p_i^f are determined by the difference between the two trade policy vectors. The prices in turn determine industry output, demand, trade flows and factor returns in each country. Given their difference, the absolute values of τ_i and τ_i^f are irrelevant for trade flows and simply determine the implicit transfer of budgetary means from the export-subsidising to the import-taxing country. If the difference between τ_i and τ_i^f were 0, p_i and p_i^f (and therefore the product and factor allocations in the two countries) would be the same as under free trade.

What else can be said about the equilibrium in equation (4.34)? It is influenced by the relative strength of the two lobbies: the lobby which has the greater stake in the negotiations (as measured by the output level *X*), which has the less benevolent government (as measured by β), and which is confronted with a smaller fraction α_F of population owning a specific factor in an organised sector, will *ceteris paribus* achieve more domestic trade intervention than its counterpart in the other country. The relative level of trade intervention is furthermore influenced by the relative price sensitivity of

import demand (or export supply, respectively). The lower this sensitivity in a country, the more intervention a lobby can expect from its government.

A last observation concerns the absence of terms-of-trade considerations in equation (4.34), in contrast to the situation of unilateral policy setting. Obviously, an efficient international trade agreement eliminates the dead-weight loss associated with the exercise of market power. There are no tariffs or subsidies any more that are *intended* to manipulate foreign prices. While this does not mean that the terms of trade are the same as under free trade, they are no *independent* source of trade intervention any more.

4.3 Dynamic aspects of the protection structure

Equation (4.34) has described an international trade agreement for an industry *i*. It is static in that it makes the structure of protection dependent on the prevailing values of variables at the time of concluding the negotiations. This equation cannot (and is not claimed to) be the entire story. When analysing the existing world trading order, two distinct features that escape a merely static view can be observed. Firstly, remember from Chapter 2 that permanent (i.e. long-term) protection levels have gradually decreased since the adoption of the GATT in 1947. Secondly, there are numerous temporary rises in protection levels, as documented in Chapter 3.

In this section, some theoretical reasoning for both features will be provided, with a clear focus on temporary deviations from initial concessions: they are the result of the institutional design of flexibility in the world trading order. Before doing so, however, it is useful to take a look at the issue of enforcement.

4.3.1 The enforcement of international trade agreements

An international trade agreement according to equation (4.34) enables the domestic government to raise its utility above the level given by the *Nash* equilibrium in equation (4.32). This claim is not inferred from a direct comparison of the two equations, since they do not comprise any measure of utility. However, if the utility level were not higher, the government would refuse to sign the respective agreement.

Defining the government utility resulting from equation (4.34) to be G^C (*C* stands for co-operation) and the utility implicit in equation (4.32) to be G^N (*N* stands for *Nash*

equilibrium), one has $G^C > G^N$. Although this inequality promotes the successful conclusion of an international trade agreement, it does not suffice to ensure that the agreement, once signed, is adhered to. It is plausible that there exists a utility level G^D (D stands for defection) with $G^D > G^C$ that can be reached by the domestic government if it subsequently defects from the agreement while the foreign government continues to co-operate. In this case of cheating, the domestic government chooses its unilaterally optimal protection structure, given the co-operative behaviour of the foreign government.

This unilaterally optimal protection structure at home is still described by equation (4.32), since the latter determines the optimal response of the domestic government to *any* foreign trade policy.[131] However, the resulting level of t_i differs between the defection strategy and the *Nash* strategy, since p_i^f and M_i^f depend on whether the foreign government plays a co-operative strategy or a *Nash* strategy.

If the foreign government played a co-operative strategy while the domestic government defected, the foreign government would achieve a utility level below G^{Cf} and even below G^{Nf}. This utility level might be described as the "sucker's payoff"[132] G^{Sf}, with $G^{Sf} < G^{Nf} < G^{Cf}$. Knowing the structure of this game and anticipating the opportunistic behaviour of the domestic government, the foreign country would not be willing to sign an agreement, but would prefer to play a *Nash* strategy. The reason for this unwillingness is an enforcement problem: if the domestic government can defect without consequence, it is only rational for it to do so. International trade agreements that do not envisage any "punishment" for defective behaviour are therefore not enforceable. However, no aggressive connotation of the term punishment is intended here. Rather, it is defined as the determination of a price for defection. It is argued that every successful trade agreement must have a punishment component.

How can a country – or, more precisely, its government – be punished? If it refused to adhere to an agreement, it might be requested to pay a price in the form of market access concessions or in the form of financial means. However, what would happen if it refused to pay? As long as drastic measures (such as embargoes or military intervention) are excluded, sovereign countries cannot be coerced into behaving in a particular way. In

[131] Equation (4.32) can be called the "tariff reaction curve" of the home country.
[132] See e.g. Rosendorff and Milner (2001), p. 839.

other words, there are natural limits to enforcement.[133] In fact, there are only two promising punishment strategies. The first is to deny a country the future benefits of co-operation by termination. In this case, a country could effectively be induced to adhere to an agreement if the short-term gain from cheating were outweighed by the loss of benefits from future co-operation. The second punishment strategy is to build up some kind of institution that is able to negatively affect the reputation of a sovereign country once it has disregarded its initial concessions. International law could be such an institution. While it is difficult to trace the precise interrelation between international law and reputation, it presumably does exist. Hudec (1990, p. 12) notes:

> True, like the Pope, international law has no army. But the Pope still makes a pretty good living without one. And so does international legal obligation. Governments do respond, not invariably but more than just occasionally. The greater a government's own reliance on the system of international rules in question, the more influence such obligations will have over its conduct.[134]

I recognise the importance of reputation in international relations and will refer to it again in the following chapter. Yet I do not formalise it here, but simply assume that it tends to reinforce the effect of a strategy that denies the future benefits of an agreement.

If, as a response to the cheating behaviour of the domestic government, future co-operation is denied by the foreign government forever, the latter is said to play a grim strategy.[135] The resulting incentive structure can be described as follows: the short-term gain[136] for the domestic government from defection is $G^D - G^C$, and the corresponding loss of benefits in any future period is $G^C - G^N$. Summing up all future periods and discounting them by a factor $\delta \in [0,1[$, the necessary condition for a successful enforcement of the international trade agreement is:

$$(4.35)\quad G^D - G^C \leq \frac{\delta}{1-\delta}\left(G^C - G^N\right).$$

[133] The commitment approach to international trade agreements regularly neglects such enforcement problems, see. e.g. Maggi and Rodríguez-Clare (1998).

[134] Kovenock and Thursby (1992), p. 168, argue that international legal obligation "[...] might be viewed as the political equivalent of 'living with one's conscience'."

[135] See Abreu (1986).

[136] "Short-term" is used to describe the period of time until the foreign country reacts to the defection of the home country.

The enforcement of an agreement becomes all the more difficult the more the future is discounted (i.e. the lower the value of δ): in the extreme case in which the government is only interested in the current period (i.e. $\delta = 0$), a grim strategy has no deterrent effect. Therefore, no agreement would be signed. In addition to this problem, the grim strategy has a second deficiency: it is costly to apply, since it is not only the domestic (defecting) government that forgoes the benefits of future co-operation, but also the foreign (punishing) government itself. One might imagine that after some periods of alleged grim strategy, the foreign government could be persuaded to again offer co-operation to the domestic government. In other words, the grim strategy is not renegotiation-proof.[137]

An appropriate consideration of the possibility for renegotiation would depend on a highly specified model, which for simplicity is not envisaged here. Instead, it is argued that the possibility for renegotiation dictates that a denial of future co-operation must realistically be restricted to an exogenous number of *T* periods. In this case, the necessary condition in equation (4.35) would become

$$(4.36)\quad G^D - G^C \leq \frac{\delta - \delta^{T+1}}{1-\delta}\left(G^C - G^N\right).$$

It is easy to verify that equation (4.35) is just a special case of equation (4.36), namely the case where $T \to \infty$. The enforcement impact of the punishment strategy increases with *T*.

Thus far, it has been assumed that an international trade agreement determines the protection structure in accordance with equation (4.34). That is, the two governments agree to set the politically optimal tariffs, leaving aside any terms-of-trade considerations. However, knowing that a trade agreement is only viable if it can be enforced, it is not clear if the agreement of equation (4.34) is feasible at all. The answer is simple: it is only feasible if equation (4.36) holds. An intuition for this condition can be gained by looking at Chart 4.1.

[137] See Downs and Rocke (1995).

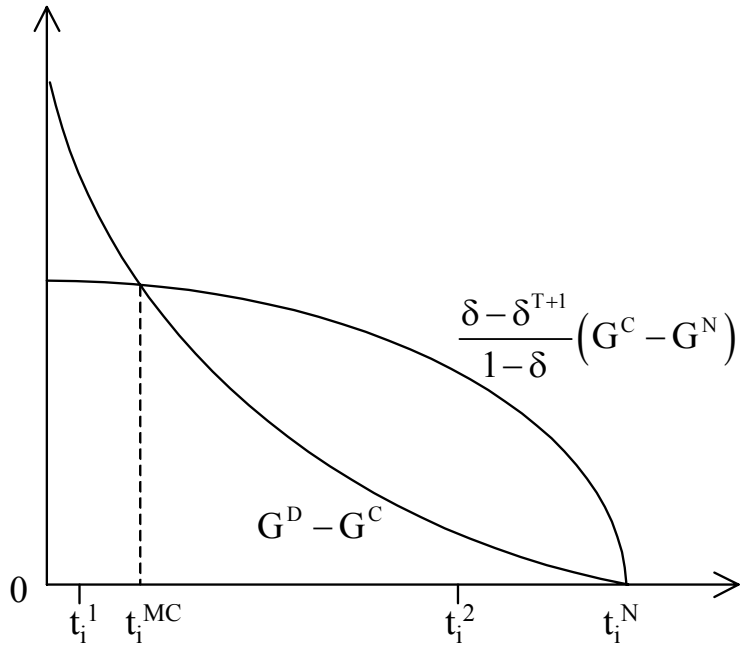

Chart 4.1: The "most co-operative" tariff level[138]

In this graph, both the short-term gain from defection and the corresponding loss due to forfeited future benefits of co-operation are plotted. Gains and losses are 0 if the trade agreement stipulates the *Nash* tariff t_i^N, since this replicates the non-co-operative outcome. If the agreement determines a tariff below t_i^N, short-term defection gains and long-term forfeit costs begin to rise. There are reasons for assuming that the defection gains have a convex shape, whereas the punishment costs are concave.[139] In this case, as the tariff level which has been agreed upon decreases, the losses first exceed the gains from defection before the two functions intersect at t_i^{MC}, which can be defined as the "most co-operative" tariff level. Afterwards, the gains from defection exceed the losses. Now, if the agreement in equation (4.34) stipulated a tariff level t_i^2, it would be self-enforcing: the government has no incentive to defect, since (discounted) future losses exceed the short-term gains from defection. What is more, future negotiations could bring about further reductions in the tariff level until t_i^{MC} is reached. If, however, the trade agreement stipulated a level of t_i^1 (or any tariff level below t_i^{MC}), it would not be enforceable, since the condition of equation (4.36) is not met any more.

[138] Adopted from Bagwell and Staiger (2002), p. 103.
[139] See Bagwell and Staiger (2002), who do not prove these properties, but provide some arguments for them.

4.3.2 The decrease of permanent protection levels: gradualism

The first feature that escapes a merely static view of the world trading order is the decrease of permanent protection levels in the framework of the GATT. Why has the successful reduction of long-term trade barriers been achieved gradually, and not instantaneously? Different explanations have been discussed in the literature. While early contributions focused on the reasons for gradualism in unilateral liberalisation, multilateral gradualism has become the topic of more recent models.[140] In principle, the latter argue that the two functions in Chart 4.1 (short-term gains of defection and the corresponding loss due to forfeited future benefits of co-operation) are time-dependent. In this sense, gradualism could be explained by a function of defection gains that shifts down over time, and/or a function of forfeit costs that shifts up. These shifts would be caused by structural changes in the economy or in the political system of a country.

As regards changes in the political system, I think of the growing influence of international organisations such as the International Monetary Fund (IMF) on developing countries in the past two decades. The IMF has regularly made the provision of financial support dependent on a more liberal attitude of the government in economic policies. An important aspect of such a liberal attitude has been the move away from import-substitution policies towards a more open trade regime. Consequently, the reduction of developing country tariffs has not only been required by international trade agreements, but also by the IMF. Therefore, the cost for a developing country associated with a defection from such a trade agreement has increased: it does not only consist of the forfeited future trade co-operation gains, but also of the threatened termination of financial support by the IMF. In other words, the engagement of the IMF has increased the potential punishment for defection.

With respect to structural changes of the economy, Furusawa and Lai (1999) provide a useful model. They assume in a two-country setting that each worker has to pay a fixed

[140] Gradualism in unilateral liberalisation was for the first time thoroughly analysed by Mussa (1986) and Leamer (1980). Later contributions came from Brainard and Verdier (1994) and Dewatripont and Roland (1992). The key argument in Mussa's paper is that adjustment costs in the import-competing sector have a convex shape: unemployment increases more than proportionately to the rate of liberalisation. Under these circumstances, it can be shown that there is an optimal rate of *gradual* liberalisation. Contributions with regard to gradualism in multilateral negotiations that are not discussed in this study come from Chisik (2003), Lockwood, Whalley and Zissimos (2001) and Staiger (1995, 1995a).

adjustment cost whenever he switches between sectors in response to a changing protection structure. In the course of liberalisation by trade agreements, this adjustment cost alters the standard trade-off between defection and observance of the agreement: as soon as the resulting adjustment cost of an initial liberalisation has been incurred and the country has adjusted towards a smaller import-competing sector, defection gains decline while the future benefits of the agreement rise. Thereby the most-co-operative tariff level decreases, making it possible to cut tariffs further in the next negotiation round.

Another explanation for multilateral gradualism is found in Devereux (1997). He argues that countries become gradually more dependent on one another if the production process in the export sector exhibits "learning by doing". An initial liberalisation effort would increase the output of the export sector. As time passes, this additional output lowers production costs, and the international trade agreement becomes more and more valuable, shifting up the curve of future benefits in Chart 4.1.

4.3.3 The temporary rise of protection levels: flexibility

4.3.3.1 General considerations

It has been argued that structural changes in the economy or in the political system of countries can lead to a modification of existing international trade agreements. In the past fifty years, these changes brought about a decreasing level of permanent protection. In the short run, however, agreements cannot be changed. Negotiations take time, and although the history of the WTO (and the GATT, respectively) is a period of almost continuous negotiation, actual modifications of agreements were only achieved in intervals of up to fifteen years, as documented in Chart 4.2.

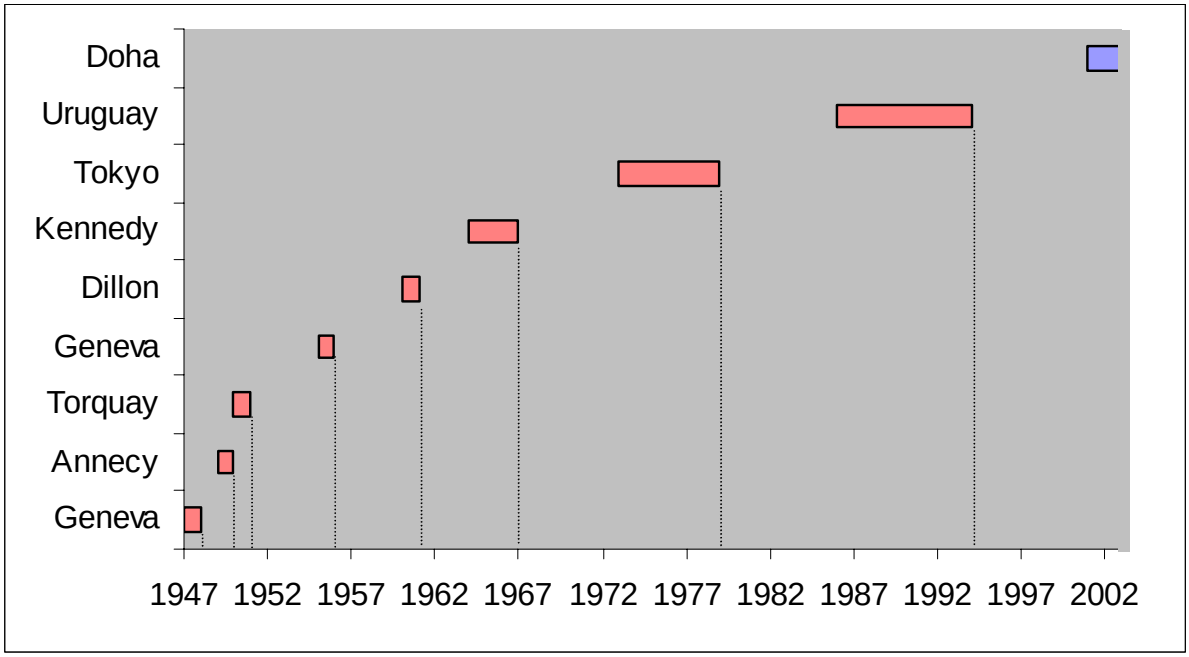

Chart 4.2: Negotiation periods of multilateral trade rounds

Unfortunately, the variables defining the structure of protection in equation (4.34) do not only encounter structural change. There are cyclical movements and temporary shocks that constantly alter their values. The degree of organisation in an industry and its access to the government (I), the ownership of inputs (α), the weighting of government objectives (β), industry size (X), trade volume (M) and world market price (p^*) are all sensitive to fluctuations in the environment. If equation (4.34) had to be fulfilled all the time, the respective international trade agreement would need a continuous fine-tuning, leading to a new structure of trade barriers virtually every day.

Such a fine-tuning is not possible. Furthermore, it is not desirable. If the protection structure were under constant revision, economic activity would be impaired due to informational costs and lack of predictability. This would have a negative impact on social welfare and the objective function of the government (assuming that β is positive). Therefore, constant revision of the trade agreement is not in the interest of the contracting parties.

Nonetheless, a government might want to modify the agreement in exceptional cases of sudden and dramatic change in one of the variables discussed above. The government may not search for permanent modification, but for temporary adjustment. For example, a

severe recession could suddenly threaten thousands of jobs in an industry. This threat would strongly improve the access of this industry to the government, so that *I* takes a value of 1 instead of 0 in the G-H model. This in turn would fundamentally alter the desired protection structure in the eyes of the government. If the difference between desired protection and the contents of an existing international trade agreement became too large, the left side of equation (4.36) might suddenly outweigh the right side, making the government feel bound to deviate from initial concessions.

Knowing that a need for deviation may arise at some future date, but knowing also that the long-term maintenance of an agreement is of considerable value, governments endow international trade agreements with mechanisms that enable a temporary deviation from the agreement without terminating it. These provide a well-defined degree of trade policy flexibility. A deviation is followed by a return to the protection structure initially agreed upon as soon as the respective government has been able to pour oil on troubled waters.

According to Rosendorff and Milner (2001), the interaction between the maintenance of an agreement and the possibility for short-term deviation can be described as a trade-off between "rigidity"[141] and "stability" of an agreement: the more rigid an agreement, the less stable (i.e. durable) it is – and *vice versa*. In their model, there are two governments confronted with political pressure from domestic organised interests. The pressure is subject to shocks, but is only observable within national boundaries. Therefore, it cannot be specified in an international trade agreement, and any agreement on trade liberalisation remains incomplete.

Rosendorff and Milner enrich the trade agreement by a flexibility device (they call it escape clause, which is also a prominent notation for the Safeguard Clause in Article XIX GATT). Each government is allowed to withdraw a concession at any time by exercising the clause and thereby raising the level of import restrictions. Using this device comes at a distinct price that enables the governments to withstand the temptation of permanent escape. After a government has raised the level of restrictions, it returns to the original level in the next period – or exercises the escape clause again. Rosendorff and Milner go on to prove that there exists an agreement with an escape possibility that *Pareto*-dominates an agreement without such a device. The parties to the agreement optimally

choose the price so that the escape clause is neither too cheap (which would induce governments to overuse it, thereby effectively disabling co-operation), nor too expensive (which might cause the breakdown of the agreement).[142]

4.3.3.2 The Ethier model

I will now have a closer look at the specific theoretical foundations of flexibility instruments. In order to make a rigorous assessment, a mechanism that provides unconfined trade policy flexibility is analysed: governments are able to decide when to restrict imports after an international trade agreement has been concluded, and *no* prerequisites need to be fulfilled. I revert to a model introduced by Ethier (2002), which I simplify and adjust to the purposes of this study.

Consider a world of two countries, home and foreign, and two sectors, *i* and *j*, in each country. The home country has its comparative advantage in *i* and the foreign country in *j*, respectively, but otherwise the two countries are identical. Sectors are able to organise themselves. Trade is balanced, the world prices of the goods *i* and *j* are 1. Both countries have a historically-given tariff level *t* on their imports.

Now, the two countries consider lowering this tariff on a reciprocal basis[143] by θ with

$$(4.37)\quad \theta = \left| \frac{dt}{1+t} \right|.$$

The objective function of the home government is sensitive to domestic relative prices and to changes of the market access balance. This balance is defined as the foreign market access for domestic exporters relative to the domestic market access for imports. It

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[141] Their use of the term corresponds well with Batigalli and Maggi (2002), see the introduction to this chapter.

[142] Using exactly the same game-theoretic model, Rosendorff (2001) substitutes the violation of an international trade agreement for a formal escape clause. Similar to the escape clause, a violation has a price in the form of being subject to the decision of an adjudication body. This price again ensures that deviations do not occur too frequently.

[143] Reciprocity is explicitly provided for in GATT Article XXVIII*bis*, dealing with tariff negotiations. Dam (1970), p. 59, notes: "From the formal legal principle that a country need make concessions only when other contracting parties offer reciprocal concessions considered to be 'mutually advantageous' has been derived the informal principle that exchanges of concessions must entail reciprocity." A pure theoretical justification for reciprocity in multilateral negotiations is provided by Bagwell and Staiger (1999, 1999a). The principle serves to neutralise the world price implications of tariff negotiations. It thereby assists governments in achieving efficient trade policy outcomes.

reflects the mercantilistic element of trade policy.[144] The objective function is formally given by[145]

$$(4.38)\quad G = \left[\varphi \frac{\Delta R_i(S,a)}{R_i} - \left(- \frac{\Delta R_j(S,a)}{R_j} \right)^{1+\gamma} \right] + \tilde{\mu}\, \Delta MA(S,a) + \tilde{\lambda}(S,a)\,.$$

For the period *after* the tariff reduction, S denotes the state of the environment and a stands for a temporary government policy action. Note that there can be two different states of the environment. In the first state, the domestic government wants to take the policy action a. In the second state, it is the foreign government that feels bound to do so.

The square brackets reflect distributional concerns of the government. R_i and R_j denote the returns of the export sector i and the import-competing sector j, respectively. Trade liberalisation increases the returns of the former and reduces those of the latter. φ denotes the relative weight that the government attaches to the export sector. Since this sector pushes for less protectionism, its interests are consistent with social welfare maximisation.[146] Therefore, if the government were indifferent as regards the returns of import-competing versus export sector, but at the same time valued social welfare, one would have $\varphi > 1$. Finally, $\gamma > 0$ is the Corden sensitivity:[147] governments avoid policies that cause a *serious* reduction in the income of any particular sector.

The change of the market access balance in response to the tariff reduction is captured by ΔMA with

$$(4.39)\quad \Delta MA = \frac{\Delta(-M_i) - \Delta M_j}{-M_i}$$

valued at initial world prices. $M_i < 0$ are the home country exports (i.e. the negative imports) of product i, $M_j > 0$ are its imports. $\tilde{\mu}$ represents the importance that the government attaches to a change of the market access balance.

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[144] Mercantilism can succinctly be summarised as: (1) exports are good; (2) imports are bad; (3) other things equal, an equal increase in imports and exports is good. See Krugman (1991). The simplified Ethier-model is limited to (1) and (2).

[145] The objective function of the foreign government is symmetric.

[146] The possibility of export subsidies is not considered.

[147] See Corden (1997).

The market access balance is dependent on the policy action *a*. If the domestic government implemented *a*, the domestic market access balance would improve due to a reduction of imports. This market access consequence is a *by-product* of the policy action, not its purpose,[148] but at any rate it requires trade policy flexibility, otherwise it could not be implemented after the agreement on a tariff cut has been concluded. It is assumed that there is no possibility of contractually specifying *a*: the trade agreement is incomplete in this respect. The term $\tilde{\lambda}(.)$ in equation (4.38) determines the *intended* contribution of *a* to government utility in the period after the tariff reduction, with $\tilde{\lambda}=0$ if $a=0$.

For reference purposes, I first exclude that one of the governments wants to take a policy action *a* in the period after having agreed on the tariff reduction. No trade policy flexibility would be needed. In this reference case, what is the optimal liberalisation rate θ^{OPT} that the two governments would co-operatively choose? In other words, what would liberalisation look like if the governments were sure that no desire for temporary deviation from initial market access concessions would arise *ex post*? Assuming that a reciprocal liberalisation at rate θ has the following consequences,

$$(4.40)\quad \frac{\Delta R_i}{R_i}=\frac{\theta}{2} \qquad \frac{\Delta R_j}{R_j}=-\frac{\theta}{2}\ ,$$

one obtains

$$(4.41)\quad G=\varphi\frac{\theta}{2}-\left(\frac{\theta}{2}\right)^{1+\gamma}+\tilde{\mu}\,\Delta MA\ .$$

For the ease of exposition, *g* is defined to be

$$(4.42)\quad g\equiv 2^{1+\gamma}G=2^{\gamma}\varphi\theta-\theta^{1+\gamma}+\mu\,\Delta MA$$

with $\mu\equiv 2^{1+\gamma}\tilde{\mu}$.

Since (1) trade is initially balanced ($-M_i=M_j=M$), (2) liberalisation is reciprocal ($\theta^f=\theta$), and (3) price elasticities of import demand are identical ($e_i^f=e_j=e$), the domestic market access balance changes after the tariff reduction by

[148] This assumption is made in order to maintain a high level of generality.

(4.43) $\Delta MA = \frac{e_i^f \theta^f (-M_i) - e_j \theta M_j}{-M_i} = 0$.

For symmetry reasons, the foreign market access balance also remains unchanged. Defining

(4.44) $r \equiv 2\varphi^{1/\gamma}$,

equation (4.42) becomes

(4.45) $g = r^\gamma \theta - \theta^{1+\gamma}$.

The optimal rate of liberalisation is derived from maximising *g* with respect to θ:

(4.46) $\frac{\delta g}{\delta \theta} = r^\gamma - (1+\gamma)\theta^\gamma \overset{!}{=} 0$

(4.47) $\theta^{OPT} = r\left(\frac{1}{1+\gamma}\right)^{1/\gamma}$.

Leaving aside the reference case, it is now assumed that one of the two countries feels bound to implement *a* after the trade agreement has been concluded, and that this action has a by-product consequence on the protection structure of this country. In other words, the action reduces *ex post* its initial liberalisation concession θ. Assuming that both countries know about this desire at the time of negotiating the agreement (there is, however, no knowledge about which country wants to take the policy action), I am interested in two features of the resulting agreement: (1) the rate of liberalisation θ (will it be the same as in the reference case, i.e. $\theta = \theta^{OPT}$?), and (2) the price ρ that the country initiating the policy action *a* has to pay, i.e. the punishment rate for the temporary deviation from initial market access concessions.

For the determination of these features, it is assumed that the two states of the environment *S* arise with equal probability and that taking an action *a* reduces a country's effective rate of liberalisation from θ to (θ - *a*). Since the rate of liberalisation θ is determined in the first step and the policy action is implemented afterwards, there is a two-stage game. The value of *a* taken in the second stage depends on θ and ρ, both agreed upon in the first stage. Following the conventional solution procedure for two-stage

games, it is necessary to solve first for the value of *a*, taking the features of the agreement as given. Subsequently, θ and ρ can be determined by backward induction.

It has been argued that the most promising punishment strategy in international trade relations is to deny a country the future benefits of an agreement. Therefore, if the state of the environment *ex post* turned out to be such that the home country takes the policy action *a*, the foreign country would respond with an immediate counteraction in proportion to *a*. The absolute level of punishment is therefore ρ*a* with ρ > 0. An immediate response is in opposition to the traditional economic literature in which it is assumed that any punishment is introduced with delay. However, it can be argued that in today's world of "instant communication and executive flexibility", any deviation could be punished instantaneously.[149]

If the home government took the policy action *a*, the domestic market access balance would change by

$$(4.48)\quad \Delta MA = \frac{e(\theta-\rho a)M - e(\theta-a)M}{M} = ea - e\rho a\,.$$

The objective functions of domestic and foreign government become[150]

$$(4.49)\quad g = r^{\gamma}(\theta-a) - (\theta-a)^{1+\gamma} + \mu(ea - e\rho a) + \lambda(a)$$

and

$$(4.50)\quad g^{f} = r^{\gamma}(\theta-\rho a) - (\theta-\rho a)^{1+\gamma} - \mu(ea - e\rho a)\,.$$

Taking θ and ρ as given, which level of *a* would the domestic government choose? a^{OPT} is derived by

$$(4.51)\quad \frac{\partial g}{\partial a} = -r^{\gamma} + (1+\gamma)(\theta-a)^{\gamma} + \mu e(1-\rho) + \frac{d\lambda}{da} \overset{!}{=} 0$$

[149] The citation stems from a 2001-version of Ethier's paper (p. 3).

[150] With $\lambda \equiv 2^{1+\gamma}\tilde{\lambda}$.

$$(4.52)\quad a^{OPT} = \theta - \left[\frac{r^{\gamma} - \mu e(1-\rho) - \frac{d\lambda}{da}}{1+\gamma}\right]^{1/\gamma} .$$

It is now possible to solve for the main features of the trade agreement (θ and ρ), determined in the first stage of the game. Remember that each government has an equal probability of turning out to be the one that wants to implement *a* after the agreement has been concluded. This assumption makes sense, since the countries only differ in their comparative advantage. Therefore, both governments have a common *ex-ante* objective function equivalent to the sum of *g* and g^f. The first-order conditions for the maximisation of this common objective function are:

$$(4.53)\quad \frac{\partial g}{\partial \theta} + \frac{\partial g^f}{\partial \theta} = g_\theta + g_a \frac{\partial a}{\partial \theta} + g^f_\theta + g^f_a \frac{\partial a}{\partial \theta} \overset{!}{=} 0$$

and

$$(4.54)\quad \frac{\partial g}{\partial \rho} + \frac{\partial g^f}{\partial \rho} = g_\rho + g_a \frac{\partial a}{\partial \rho} + g^f_\rho + g^f_a \frac{\partial a}{\partial \rho} \overset{!}{=} 0$$

Assuming again that it will be the domestic government that implements the policy action after θ and ρ have been determined,[151] $g_a = 0$ because the domestic government chooses *a* optimally. Equations (4.53) and (4.54) are then solved by

$$(4.55)\quad \rho = 1$$

and

$$(4.56)\quad \theta = a + r\left(\frac{1}{1+\gamma}\right)^{1/\gamma} = a + \theta^{OPT} .$$

Equation (4.55) shows that the agreement between the two countries determines punishment to be commensurate (i.e. "tit-for-tat"): the price for implementing *a*, which has reduced the level of liberalisation initially agreed upon, is an equivalent suspension of

[151] The two governments only know that *one of them* will take the trade policy action. However, since the countries are symmetric, I can proceed *as if* it were known in the first stage already that it is the domestic government that will do so.

market access concessions by the other country. In other words, the only consequence of the temporary policy action is a response by the negatively-affected country that restores reciprocity. It is not in the interest of this country to retaliate forcefully by, for example, terminating the trade agreement. On the other hand, although the model makes clear that governments deliberately choose not to exclude it, trade policy flexibility is not a "free lunch".

While the model considers a suspension of concessions for restoring reciprocity, nothing in the model conflicts with the idea that a commensurate price for trade policy flexibility is equally appropriate when reciprocity is restored by compensation in the form of trade-liberalising measures. I will make use of this result when proposing full compensation as an inherent element of trade policy flexibility in Chapter 6. Compensation is clearly preferable to the suspension of concessions, since it is trade-promoting rather than trade-inhibiting. Yet I am aware that compensation can only be enforced if the ultimate threat of a suspension of concessions continues to exist.

In addition to the result of a commensurate price, equation (4.56) offers another astonishing fact: it states that the rate of liberalisation will correspond to the optimal rate θ^{OPT} *after* the domestic government has taken the policy action *a*. This means that if no such action were taken, the two governments would experience more liberalisation than co-operatively determined in a world where no desire for deviation exists. In other words, when determining the rate of liberalisation θ, the two parties explicitly account for the fact that one of them will subsequently deviate in the form of a temporary policy action.

* * *

In the following chapter, I will argue that the violation of a WTO agreement represents a flexibility instrument without prerequisites, i.e. an instrument as portrayed in the model above. An inspection of the DSU confirms that WTO members have acted similarly to what the model predicts when negotiating the agreement. Article 22:4 reads: "The level of suspension of concessions or other obligations authorised by the DSB shall be equivalent to the level of the nullification or impairment." The nullification or impairment can be thought of as being the by-product of a policy action *a*, and the suspension of concessions

or other obligations is the level of ρ. In fact, the DSU establishes commensurate punishment.[152]

Commensurate punishment is also provided for by the Safeguard Clause. Article 8:2 of the Agreement on Safeguards reads:

> [T]he affected exporting Members shall be free, not later than 90 days after the [safeguard] measure is applied, to suspend, upon the expiration of 30 days from the day on which written notice of such suspension is received by the Council for Trade in Goods, the application of substantially equivalent concessions or other obligations under GATT 1994, to the trade of the Member applying the safeguard measure, the suspension of which the Council for Trade in Goods does not disapprove.

As regards the level of θ which has been agreed upon, it is more difficult to empirically verify the result of equation (4.56). What can be observed is the past rate of actual multilateral liberalisation *in the presence* of trade policy flexibility, provided for in WTO agreements (or in the GATT, respectively). However, it is hard to find out which rate of liberalisation governments would have chosen in the counterfactual case in which trade policy flexibility is excluded since such a system does not exist on a multilateral level. A possible indication might be attained from determining the correlation between the actual rate of liberalisation and the degree of trade policy flexibility in *regional* trade agreements. There, a broad sample with different characteristics is available, possibly providing the variation required for an econometric study.

[152] One problem with the congruence of the DSU and the model is that there is no instant retaliation in reality. The model should be read as a base case that either has instant adjudication or that predicts retroactive punishment if the DSB procedure takes time.

5 The Current Institutional Design

After having discussed the theoretical foundations of trade policy flexibility, it is time to look more closely at its current institutional design in the world trading order. Chapter 2 listed a large number of trade policy tools that offer temporary protection. However, only a few of them are able to provide trade policy flexibility as defined for the purposes of this study. The four instruments of the short list in Chapter 2 (Safeguard Clause, antidumping, countervailing duty, violation of WTO agreements) are now individually analysed, using a set of predefined criteria. The analysis of each instrument is complemented by some information on its historical background and an overview of existing suggestions for reform.

My criteria for analysing flexibility instruments can be categorised into five groups:

(1) Preliminary stage: What has to be observed before an instrument can be used, what kind of economic circumstances have to prevail?

(2) Form of protection: How are imports restricted?

(3) Balancing: What happens to trading partners who are negatively affected, how can they react?

(4) Control: Is the use of an instrument monitored, is its need verified?

(5) Developing countries: Are there special rules that take into account their developmental requirements?

Chart 5.1 shows the different criteria that I have allocated to each of the five groups and provides a short definition. Their meaning will become more clear once they are applied in the analysis of the four flexibility instruments.

Category	Criteria	Definition
Preliminary stage	Prerequisites	Set of economic circumstances that have to prevail before the instrument may be used. Example: serious injury
	Investigation	Fact-finding activities by national authorities regarding the prevailing economic circumstances
	Notification	Provision of information to the WTO about the introduction of an import-restricting measure or about a respective investigation
	Consultation	Opportunity for negatively-affected trading partners to discuss the import restriction
Form of protection	Selectivity	Possibility of excluding certain trading partners from an import restriction (discrimination)
	Measure	Nature of the import restriction. Examples: tariff increase, quantitative restriction
Balancing	Compensation	Extent to which negatively-affected trading partners are reimbursed for the loss incurred by the import restriction.
	Suspension	Suspension of concessions by trading partners in reaction to the introduction of the import-restricting measure
Control	Surveillance	Existence of a WTO body that monitors and analyses the use of the flexibility instrument by individual WTO members
	Duration	Maximum period of time during which a measure may be applied, including a possible extension
	Review	Renewed fact-finding activities by the national authorities regarding the prevailing economic circumstances after some time
	Adjustment	Provisions requiring adjustment measures in the industry protected by the flexibility instrument
Developing Countries	Special Provisions	Example: higher prerequisites for the use of the flexibility instrument when applied against imports of developing countries

Chart 5.1: Criteria for the analysis of flexibility instruments

5.1 The Safeguard Clause

5.1.1 Historical background

The incorporation of the Safeguard Clause into the GATT in October 1947 was primarily promoted by the US, which had introduced a similar clause in its Reciprocal Trade Agreement with Mexico in 1942.[153] The US behaviour was symptomatic: it underlines the fact that those forces which apparently are the strongest advocates of liberal trade policies – as the US certainly was at that time – are also insisting that any liberalisation must be accompanied by appropriate devices ensuring trade policy flexibility.

Despite the fact that the Safeguard Clause was barely amended until the conclusion of the Uruguay Round,[154] there have always been intensive debates about possible modifications. Many of these discussions have focused on the issue of selectivity, i.e. the question whether temporary import restrictions can be introduced on a discriminatory basis. The original Safeguard Clause contained no provision on this issue. Although the mainstream interpretation of Article XIX has been in favour of non-discrimination,[155] there have repeatedly been prominent voices arguing against this perception.[156] Suggestions for modification towards an explicit recognition of discrimination were particularly pronounced when Japan became a contracting party to the GATT in September 1955. Since no accord was reached, a number of countries resorted to Article XXXV GATT,[157] while others negotiated bilateral agreements with Japan that included special safeguard clauses. Some countries chose none of these solutions, but nonetheless openly discriminated against Japan.[158]

In the sixties, trade in textiles started to be regulated by sector-specific arrangements that led to the establishment of the Multifibre Arrangement, entering into force in January

[153] See Jackson (1997).
[154] The amendments are detailed in a Background Note by the GATT Secretariat of 16 September 1987, Document No. MTN.GNG/NG9/W/7.
[155] See e.g. Document No. L/76 (1953) of a GATT working party or the panel report in *Norway – Restrictions on Imports of Certain Textile Products*, adopted on 18 June 1980, Document No. L/4959-27S/119.
[156] Jackson (1997), p. 195ff, mentions the respective position of the EC and some Scandinavian countries in the Tokyo Round negotiations, which was strongly opposed by developing countries that saw themselves as primary targets. The position of the US has varied over time.
[157] Article XXXV GATT enables a contracting party not to apply the GATT in relation to a new contracting party.
[158] See a Note by the GATT Secretariat of 16 April 1987, Document No. MTN.GNG/NG9/W/1.

1974. Article 3 of the Arrangement explicitly permits the imposition of discriminatory import restrictions when imports cause or threaten to cause "market disruption". In addition to the maintenance of import quotas, the recognition of discrimination was a second key element that has given rise to the exceptional character of textiles in the world trading order.

The issue of selectivity attracted renewed attention when the number of VERs and Orderly Marketing Arrangements (OMAs) surged during the seventies. VERs and OMAs gradually undermined Article XIX GATT, since they were inevitably discriminatory in nature. Observers argued that the move towards these intransparent bilateral agreements could be slowed down if the gap between the Safeguard Clause and VERs/OMAs with respect to selectivity were reduced. An informal proposal of June 1982 for a reform of the Safeguard Clause envisaged discriminatory measures in "exceptional and unusual" circumstances.[159] However, divergent views among the contracting parties made it impossible to come to a formal agreement.

Nonetheless, it became a widespread opinion that the Safeguard Clause would have to undergo substantial reform, far beyond the selectivity issue. A ministerial declaration of November 1982 argued for a comprehensive understanding that should include detailed rules on transparency, coverage, the concepts of serious injury or threat thereof, duration, degressivity, structural adjustment, compensation, retaliation, and control.[160] The ministerial declaration adopted in Punta del Este in September 1986, which formally launched the Uruguay Round, enumerated the same elements.

In January 1995, the new Agreement on Safeguards entered into force. It has been called "a substantial achievement, and indeed a heroic statement of principle."[161] Except for structural adjustment, which is still not required, the agreement addresses all elements brought up by the ministerial declaration of November 1982. After the adoption of the Agreement, the continuing applicability of Article XIX GATT has been controversial.[162] The question is of particular importance as regards the two prerequisites of "unforeseen developments" and "obligations incurred" as causes for increasing imports. Both

[159] See the preceding footnote.
[160] See the Ministerial Declaration of the Thirty-Eighth Session at Ministerial Level, adopted on 29 November 1982.
[161] Jackson (1997), p. 201.
[162] See Lee (2002, 2001, 2000) and Messerlin (2000).

prerequisites figure prominently in Article XIX, but the corresponding Article 2:1 of the Agreement on Safeguards does not mention them any more. Although this omission makes the two prerequisites somewhat more ambiguous, there is no reason to assume that they have lost their validity.[163]

5.1.2 Analysis

The prerequisites of a flexibility instrument were defined to be a set of economic circumstances that must prevail at the time of its use. The Safeguard Clause is an excellent instrument to exemplify the concept of prerequisites, since Article XIX GATT and the Agreement on Safeguards include a substantial number of them. Furthermore, some panel and Appellate Body decisions help to gain a better understanding of their meaning.

The prerequisites of the Safeguard Clause are summarised in Article XIX:1 GATT:

> If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions, any product is being imported into the territory of that contracting party in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the contracting party shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession.

The evaluation of prerequisites starts most easily by separating the two types of causal relationship in the paragraph. Firstly, there must be increasing imports, and this increase must be caused by unforeseen developments and by effects of the obligations incurred under the GATT. Secondly, there must be serious injury in the respective import-competing industry, caused by the increased level of imports.

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[163] In both *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, and *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products*, WT/DS98/AB/R, the Appellate Body explicitly refers to "unforeseen" circumstances, see Para. 94 and Para. 87, respectively. In *US – Safeguard Measures on Imports of Fresh, Chilled, Frozen Lamb Meat from New Zealand and Australia*, WT/DS178/AB/R, it emphasises the full and continuing applicability of Article XIX GATT, see Para. 70.

Although the determination of an increase in imports (absolute or relative to domestic production) seems to be a simple task by use of national trade and production statistics, in reality it is not. For example, neither Article XIX nor the Agreement on Safeguards provide an indication about the time horizon (the so-called reference period) between the lower and the higher import level from which the increase can be inferred. In the *Footwear* case, the Appellate Body argued that "[...] it is not enough for an investigation to show simply that imports of the product are more this year than last year – or five years ago. [...] [T]he increase in imports must have been recent enough, sudden enough, sharp enough, and significant enough, both quantitatively and qualitatively, to cause or threaten to cause 'serious injury'".[164] While it is no perfect guidance, this statement exacts pressure on investigating authorities not to make a comparison between two arbitrarily chosen points in time.[165]

If, at the time of making tariff concessions, it could have been presumed that imports would rise to a certain degree, an actual rise to this expected extent cannot justify the use of the safeguard instrument. Rather, the increase in imports must have been unforeseen. A prominent instance in which this prerequisite had to be judged was the *Hatter's Fur* case in 1951. The US introduced restrictions against imports of felt hats, mainly from Czechoslovakia. It was argued that a change in hats' fashion, presumably the origin of rising imports, could not have been foreseen in this order of magnitude. A GATT working party agreed with this view and did not contest that the prerequisite of unforeseen developments was fulfilled.[166] Critics of the decision have argued that it paved the way for an interpretation according to which virtually anything could be an unforeseen development.[167] This critique, however, is in contrast to today's strict attitude of the Appellate Body, which emphasises that unforeseen developments "[...] must be

[164] *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, Para. 131.
[165] For a comprehensive critique on how the US authorities concluded in the recent *Steel* case (the investigations starting in July 2001) that steel imports had increased, see Durling (2002). The panel report in *US – Definitive Safeguard Measures on Imports of Certain Steel Products*, WT/DS248, 249, 251, 252, 253, 254, 258, and 259, found that the respective methods are for the better part inconsistent with Articles 2.1 and 3.1 of the Agreement on Safeguards. The Appellate Body confirmed the inconsistency in its report dated 10 November 2003.
[166] See the *Report on the Withdrawal by the United States of a Tariff Concession Under Article XIX of the GATT*, 27 March 1951, Document No. CP/106.
[167] See Jackson (1997).

demonstrated as a matter of fact in order for a safeguard measure to be applied consistently with the provisions of Article XIX of the GATT 1994."[168]

Increased imports must cause serious injury in the respective import-competing industry. Again, neither the injury concept, the definition of the affected industry, nor the causal relationship between rising imports and injury are straightforward. As regards the affected industry, it must be a producer of like or directly competitive products in order to be eligible for temporary protection. While an economist has problems to establish criteria for the likeness of a product, direct competitiveness clearly relates to the concept of elasticity of substitution: product *A* is directly competitive to product *B* if a rise in consumption of *A*, all else equal, reduces consumption of *B*, and *vice versa*. Serious injury is defined in Article 4:1 of the Agreement on Safeguards. It means a "significant overall impairment in the position of a domestic industry." The threat of serious injury defines a "serious injury that is clearly imminent." Its determination must "[...] be based on facts and not merely on allegation, conjecture or remote possibility."

In addition to defining the concepts of serious injury and threat thereof more precisely, the Agreement provides guidance on how to conduct an appropriate injury assessment (Article 4:2(a)). Apart from the nature of an increase in imports, the competent authorities should consider "the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilisation, profits and losses, and employment." Although all of these injury factors must be evaluated, neither need they be weighted equally in the analysis, nor should the analysis of impairment be confined to them. Rather, *all* relevant factors should be examined in a given case.[169] In other words, the list contained in Article 4:2(a) is not exhaustive.

The causal link between increased imports and serious injury (or threat thereof) is the subject of Article 4:2(b) of the Agreement. The link must be demonstrated "on the basis of objective evidence". Furthermore, there is a non-attribution requirement: "When factors other than increased imports are causing injury to the domestic industry at the same time, such injury shall not be attributed to increased imports." Although this is a sensible

[168] *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products*, WT/DS98/AB/R, Para. 85, and *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, Para. 92.
[169] See *US – Definitive Safeguard Measures on Imports of Wheat Gluten from the EC*, WT/DS166/AB/R, Para. 55.

prerequisite, it is difficult to establish – and has given rise to controversy in the past. In the *Wheat Gluten* case, the panel argued that the non-attribution provisions

> [...] require that a Member demonstrate that the increased imports, under the conditions extant in the marketplace, *in and of themselves*, cause *serious* injury. [...] There may be multiple factors present in a situation of serious injury to a domestic industry. However, the increased imports must be sufficient, in and of themselves, to cause injury which achieves the threshold of "serious" as defined in the Agreement.[170]

Although the Appellate Body underlined "[...] the need to distinguish between the effects caused by increased imports and the effects caused by other factors [...]", it weakened the argument of the panel by stating that this distinction "[...] does *not* necessarily imply [...] that increased imports *on their own* must be capable of causing serious injury, nor that injury caused by other factors must be *excluded* from the determination of serious injury."[171] It suffices that the causal link between rising imports and serious injury "[...] involves a genuine and substantial relationship of cause and effect between these two elements [...]". The Appellate Body confirmed this attitude in the *Lamb* case.[172] It follows that the requirement of causal link is somewhat relaxed,[173] but that the isolation of increased imports from other potentially harmful factors remains an important prerequisite. Even though increased imports alone need not be capable of causing serious injury, they must significantly contribute to the impairment of the respective import-competing industry. The isolation procedure must be carried out thoroughly, as the Appellate Body requested in the *Line Pipe* case:[174]

> [T]he competent authorities must establish explicitly, through a reasoned and adequate explanation, that injury caused by factors other than increased imports is not attributed to increased imports. This explanation must be clear and

[170] *US – Definitive Safeguard Measures on Imports of Wheat Gluten from the EC*, WT/DS166/R, Para. 8.138 (emphasis in the original).
[171] *US – Definitive Safeguard Measures on Imports of Wheat Gluten from the EC*, WT/DS166/AB/R, Para. 69 and 70 (emphasis in the original).
[172] See *US – Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat From New Zealand and Australia*, WT/DS177/AB/R.
[173] The Appellate Body has been strongly criticised for this attitude, see Palmeter (2001). For a discussion see also Vermulst and Graafsma (2001).
[174] *US – Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea*, WT/DS202/AB/R, Para. 217.

unambiguous. It must not merely imply or suggest an explanation. It must be a straightforward explanation in express terms.

In order to find out if all prerequisites are fulfilled, the competent authorities have to undertake a thorough investigation. Article 3 of the Agreement on Safeguards requires that such an investigation includes "reasonable public notice" and "public hearings" for all interested parties, including foreign exporters. According to Article 12, the initiation of an investigatory process shall immediately be notified to the WTO Committee on Safeguards. Furthermore, a notification must be made upon a finding of serious injury (or threat thereof) caused by increased imports and upon taking a decision to apply a safeguard measure. This notification shall include respective evidence and a "precise description of the product involved and the proposed measure, proposed date of introduction, expected duration and timetable for progressive liberalisation." In the *Dairy Products* case, the Appellate Body argued that an evaluation of all injury factors of Article 4:2 should be included in the notification.[175]

Except for the case in which "critical circumstances"[176] prevail, "[...] adequate opportunity for prior consultation with those Members having a substantial interest as exporters of the product concerned [...]" must be provided.[177] The Appellate Body requested that "exporting members [should be provided] with sufficient information and time to allow for the possibility, through consultation, for a meaningful exchange on the issues identified."[178]

As regards the selectivity issue, Article 2:2 makes clear that "[s]afeguard measures shall be applied to a product being imported irrespective of its source." This is a strong statement in the light of the decade-long controversy described above. However, the advocates of selectivity managed to introduce an important qualification of the non-discrimination principle in Article 5:2(b): WTO members may use quantitative restrictions in order to temporarily raise import barriers, and when they do so, they may depart from a non-discriminatory allocation of quotas, provided that

[175] See *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products*, WT/DS98/AB/R, Para. 108.
[176] Article 6. The exception is also stated in Article XIX:2 GATT. According to WTO (1995), this provision was applied in a large number of cases before the conclusion of the Uruguay Round.
[177] Article 12:3. Emphasis added.

(i) imports from certain members have increased in disproportionate percentage in relation to the total increase of imports of the product concerned in the representative period,

(ii) the reasons for the departure [...] are justified, and

(iii) the conditions of such departure are equitable to all suppliers of the product concerned.

Such a departure is not permitted in the case of threat of serious injury. It can be concluded that discrimination is possible under the Agreement on Safeguards, although its exercise must not be based on arbitrary reasons.[179]

The question of compensation when taking a safeguard measure on the one hand and the suspension of concessions by negatively-affected trading partners on the other hand are dealt with in Article XIX GATT and in Article 8 of the Agreement on Safeguards. Article XIX does not explicitly mention compensation. However, it is taken for granted that the potential "agreement" envisaged in Paragraph 3(a) between the country using the Safeguard Clause and the negatively-affected trading partners should include compensatory measures. As mentioned in Chapter 3, there were at least twenty cases in the past in which compensation was actually provided. Compensatory measures must fulfil the MFN requirement. If, however, the parties fail to reach an accord about compensation, trading partners are allowed to suspend substantially equivalent concessions to the trade of the contracting party requesting the safeguard measure. This suspension is discriminatory, i.e. it may not impair the market access of third countries. Therefore, in addition to raising the level of barriers to trade, the suspension brings about a distortion by neglecting the MFN principle.

Article 8 of the Agreement on Safeguards replicates the relationship between compensation and the suspension of concessions stipulated in Article XIX GATT. Again, compensation is the mechanism preferred to maintain the original market access balance.

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[178] *US – Definitive Safeguard Measures on Imports of Wheat Gluten from the EC*, WT/DS166/AB/R, Para. 136.

[179] Bown and McCulloch (2003) describe different ways by which quantitative restrictions discriminate among trading partners, and provide empirical evidence. Firstly, quantitative restrictions preserve historical market shares. They discriminate thereby against faster growing exporters and against new

Only if no accord can be achieved, should negatively-affected trading partners resort to the suspension of concessions. However, the Agreement on Safeguards has brought two noteworthy innovations compared to Article XIX GATT. Firstly, compensation is not only explicitly mentioned in Paragraph 1 of Article 8, but it is also qualified by the word "trade". This underlines that compensation is supposed to take the form of trade liberalising measures in sectors unrelated to the protected industry – and is not of a monetary nature, although financial transfers are probably not forbidden. Secondly, when a safeguard measure is taken in response to an *absolute* increase in imports (i.e. not a mere increase relative to domestic production), "the right of suspension [...] shall not be exercised for the first three years that [the] safeguard measure is in effect". What implication does this have for compensation? Although compensation is ultimately dependent on the outcome of bilateral negotiations and therefore not bound to a particular level, the introduction of a three-year period in which the suspension of concessions may not be envisaged can also be interpreted as a corresponding reduction of the compensation requirement.

The Committee on Safeguards, established in Article 13, is responsible for surveying the smooth implementation of the Agreement. According to Article 7, a safeguard measure should be applied "only for such period of time as may be necessary to prevent or remedy serious injury". After four years at the latest, the measure shall cease to exist, except if it is extended after a review by the competent authorities has revealed that the measure continues to be necessary to prevent or remedy injury. The total period of application, i.e. the duration of a safeguard measure, shall not exceed eight years.

In spite of the fact that the Agreement on Safeguards explicitly deals with the facilitation of adjustment as the primary purpose of the safeguard measure,[180] there is no formal requirement to introduce adjustment measures in the protected industry. This has been confirmed by a panel in the *Dairy Products* case,[181] which ruled that Article 5:1 does not prescribe the establishment of an adjustment plan, although it requires that a safeguard measure shall be applied only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment.

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entrants. Secondly, formal exemptions for partners in regional trade agreements and for small developing country suppliers allow these countries to gain market share at the expense of others.

[180] See the Preamble and Articles 5:1, 7:1, and 7:4.

[181] See *Korea - Definitive Safeguard Measure on Imports of Certain Dairy Products*, WT/DS98/R.

Finally, the Agreement includes in Article 9 a few special provisions for developing country members. Firstly, a developing country must not become the target of a foreign safeguard measure as long as its import share in the protected market does not exceed three percent (provided that developing country members with less than three percent import share collectively account for not more than nine percent of total imports of the product in question). Furthermore, if a developing country wants to use the safeguard instrument itself, it can extend the period of application beyond the maximum time admissible for developed countries.

5.1.3 Existing suggestions for reform

Most existing suggestions for the reform of the Safeguard Clause are directed towards clarification of the rules stipulated in the Agreement on Safeguards. Lee (2002) and Lee and Mah (1998) provide an overview of critical issues: clarifications are needed with regard to the standard of review, the treatment of confidential information, the determination of serious injury and threat thereof, the timing of notifications and consultations, the guidelines for the mid-term review and for the reference period during which the rise in imports is measured.

Another strand of suggestions, which is of a more substantive nature, focuses on the compensation dimension of the Safeguard Clause. Steps towards reducing compensation have already been taken within the framework of the Uruguay Round: a result was the *de-facto* abolition of the compensation requirement for a three-year time period in the case of absolutely increasing imports. Remember that I have inferred this from the corresponding prohibition of a suspension of concessions. However, there are observers who would like to go even further by completely eliminating compensation.[182]

Interestingly enough, there are no suggestions considering a reduction of prerequisites. This is surprising in view of claims that the Safeguard Clause is not sufficiently attractive in relation to other flexibility instruments (notably antidumping) and therefore

[182] See e.g. Hoekman and Leidy (1989). Actually, the compensation component of the Safeguard Clause fell in disgrace long ago. Tumlir (1974) considered that "Article XIX is, at one and the same time, too exacting and too lenient" (p. 262). Whereas "lenient" refers to the fact that temporary protection could become permanent, the requirement to compensate is "too exacting". In this spirit, Robertson (1992) is convinced that "[r]eciprocity has no place in dealing with *temporary* emergency actions if they are properly supervised" (p. 47, emphasis in the original).

unpopular.[183] In marked contrast, a few authors have suggested *raising* the level of prerequisites. For example, Lee and Mah (1998) want the Agreement to specify that imports must be the "major" cause for serious injury or threat thereof.[184]

5.2 Antidumping

5.2.1 A brief introduction to the economics of dumping and antidumping

Dumping occurs when a product is sold on a foreign market below the price that the exporter charges for the same product on his domestic market. Following the classical dumping theory of Viner (1923, p. 3), who defined dumping more generally as a "price-discrimination between national markets", dumping can be categorised "according to motive and continuity". This is done in Chart 5.2.

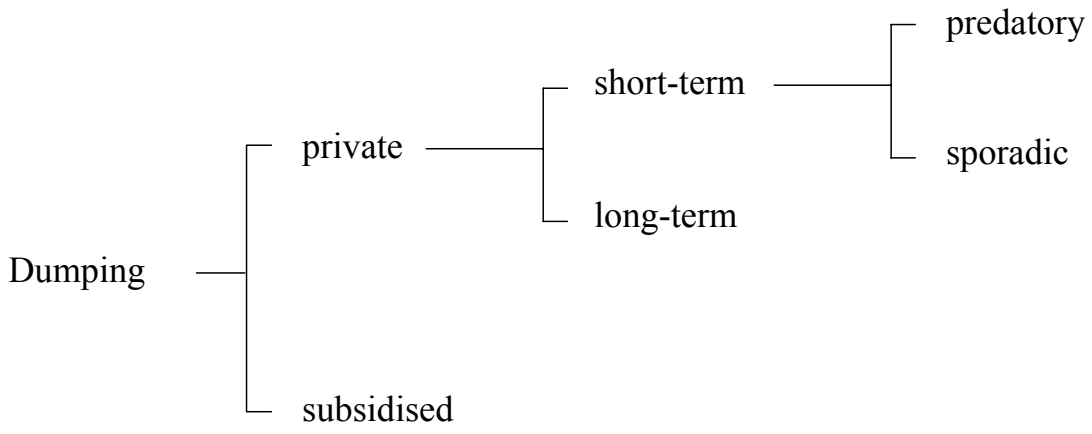

Chart 5.2: A categorisation of dumping

The discussion of subsidised dumping is postponed to Section 5.3. Although no firm would deny that it is in its interest to weaken competitors (this is in fact what competition is all about), private long-term dumping is not aimed at *eliminating* foreign firms. Rather, it is the profit-maximising strategy of a firm that is confronted with a less elastic demand curve for its product at home than abroad. Sporadic dumping results as a by-product of variations in production (such as, for example, harvest fluctuations) or of unforeseen

[183] See in particular Bown (2002).

[184] They argue on p. 29 that "[i]n the present environment in favour of free trade, the protectionist interest that the safeguard actions attempt to guard would be subject to high scrutiny. Therefore, the required causality in the Agreement between the import and the injury/threat of injury must be substantially proven. The Agreement needs to specify that the import must be the 'major' cause for the injury/threat of injury."

demand changes. Again, the intention behind it is not anticompetitive. Finally, there is predatory dumping. This form of price-undercutting is not merely a manifestation of different demand elasticities or swaying market conditions, but a deliberate technique to drive away foreign competitors from their domestic markets. It aims at raising prices as soon as meaningful competition has disappeared.

Economic theory is quite unanimous as to the question of whether dumping ought to be countered by import countries from a social welfare perspective or not. The tenor is that there is no rationale for antidumping action as long as dumped imports are not based on an anticompetitive strategy.[185] In terms of the categorisation in Chart 5.2, there should be no antidumping in the case of private long-term or sporadic dumping. Only in the case of predatory intent could economists agree that antidumping is useful in order not to impair social welfare.

5.2.2 Historical background

Antidumping as a trade policy device existed long before the Second World War. Canada was the first country to have its own antidumping law, introduced in 1904 as a response to US exports of steel. The following table gives an overview of the year of implementation of antidumping laws by major countries:

[185] See e.g. Corden (1997) or Trebilcock and Howse (1999).

Country	Year
Canada	1904
Australia	1906
South Africa	1914
US	1916
Japan	1920
New Zealand	1921
France	1921
United Kingdom	1921
Germany	1951
South Korea	1963
EC (common policy)	1968
Argentina	1972
India	1985
Mexico	1986
Brazil	1987
China	1997
Russia	1998

Chart 5.3: Year of implementation of antidumping laws[186]

Due to the strong presence of antidumping before the establishment of the GATT in 1947, it is not surprising that the Agreement included from the beginning a special clause on dumping and antidumping action, namely Article VI. This article did not ban dumped exports, which would not have been possible anyway: the GATT sets rules for government trade policy, and not for the behaviour of private firms.[187] However, it made clear that dumping should be condemned "[...] if it causes or threatens material injury to an established industry in the territory of a contracting party or materially retards the establishment of a domestic industry." Remembering the economics of dumping discussed above, one would like to interpret this phrase as condemning predatory intent only. Unfortunately, such an interpretation would be far too narrow. Injury can also be caused by perfectly competitive behaviour, and it is therefore obvious that Article VI is applicable to a much broader category of foreign behaviour than recommended by sound economic reasoning. As a consequence, some countries soon felt that their firms were

[186] Data from Zanardi (2002).

[187] Nonetheless, New Zealand proposed in 1954 the modification of Article VI to provide that members "shall refrain from action which would cause or encourage dumping" causing injury to the industry of other members. New Zealand did not gain acceptance with other members. See the *GATT Proposals by the New Zealand Government*, Document No. UN Doc. L. 270/Add. 1.

confronted with unwarranted antidumping measures by foreign trading nations. A controversy about possible amendments to the antidumping regime started.

In 1967, at the occasion of the Kennedy Round, an antidumping code was adopted.[188] The code was intended to clarify and supplement Article VI GATT and required that the alleged dumping be the principal cause of material injury.[189] It was signed by 17 countries. The Tokyo Round brought about a new code in 1979, having 25 signatories. Although there was an effort to establish more detailed specifications for national antidumping procedures, it further broadened the applicability of the antidumping instrument. Both the inclusion of sales below cost for the definition of "less than fair value" and the abolition of the requirement that dumped imports be the principal cause of material injury[190] opened a door for temporary protection that was without precedent in the history of the GATT. Rapidly, it was perceived that antidumping would have to be part of the agenda again in the Uruguay Round.

The conclusion of the Uruguay Round Agreement on Antidumping has been celebrated as "[...] a reversal of a tendency to make the imposition of antidumping easier."[191] The rising popularity of antidumping after the end of the Round, evident in the numbers of Chapter 3, must in hindsight be striking for those who have expected that the new Agreement would reduce its attractiveness. This hope has been raised by apparent attempts to introduce higher prerequisites for the use of the instrument. For example, Article 5:8 provides for a new *de-minimis*-rule, which states that "[t]here shall be immediate termination [of investigation] in cases in which the authorities determine that the margin of dumping is de minimis, or that the volume of dumped imports, actual or potential, or the injury, is negligible." Another rise of prerequisites seemed to come from reduced discretion with respect to a variety of technical methodologies. In this respect, Article 2:4 requires making a "fair comparison" of prices when calculating the dumping margin. In particular, the comparison must be either on an average-to-average or on a transaction-to-transaction basis. Obviously, however, something went wrong on the way to successfully restrict the use of antidumping.

[188] See the *Agreement on the Implementation of Article VI*, 30 June 1967.
[189] See Gingerich (1998).
[190] See Blonigen and Prusa (2001).
[191] Horlick and Shea (1995), p. 5.

5.2.3 Analysis

The Agreement on Antidumping has 18 articles and two annexes. However, the main contents – both in terms of importance and in terms of controversy – can be found in Article 2 ("Determination of Dumping") and Article 3 ("Determination of Injury"). The two articles in essence describe what I have termed above the prerequisite criterion. The prerequisites of the antidumping instrument are nowadays extremely low.

Since dumping is the (positive) difference between the price of a product when sold on the domestic market of the exporter and the price of the same (or the "like") product when sold on the export market, Article 2 establishes the rules on how to calculate these two prices. The latter price is the "export price", the former is called "normal value". The term value is used instead of price because normal value can also stand for the production costs of a product, used as a proxy for the price. Actually, this proxy method is at the core of the antidumping critique.

Even if reliable data on export price and normal value were available, and a reasonable comparison of the two figures were possible, a positive finding of dumping should not necessarily lead to antidumping action, as outlined above. However, the Agreement on Antidumping is far from providing guidance on the reliable use of data and on the establishment of an appropriate comparison. The reason for such a conclusion is the significance of constructed values in the Agreement, both with regard to export price and normal value. The construction of such values is dangerous because it is prone to arbitrary, intransparent determinations. It is even more dangerous in cases of large deference to national authorities, i.e. when the decisions of the latter can hardly be overturned by a multilateral body such as the DSB. A substantial deference is stipulated in Article 17:6 of the Agreement on Antidumping, which states that

> [...] the panel shall determine whether the authorities' establishment of the facts was proper and whether their evaluation of those facts was unbiased and objective. If the establishment of the facts was proper and the evaluation was unbiased and objective, *even though the panel might have reached a different conclusion,* the evaluation shall not be overturned.[192]

[192] Emphasis added. Only the Agreement on Antidumping has its own standard of review. For the evaluation of factual and legal determinations of domestic agencies in safeguard and countervailing

Although the Appellate Body made clear in *Hot-Rolled Steel* that a panel has to make "an active review or examination of the pertinent facts",[193] Article 17:6 documents that WTO members wanted to tightly restrict the multilateral jurisdiction with regard to the determination of dumping and material injury.[194]

Now, back to the prices. As regards the export price, Article 2:3 permits that investigating authorities construct the export price "[...] where it appears [...] that the export price is unreliable because of association or a compensatory arrangement between the exporter and the importer or a third party [...]". This provision is intended to counteract the fear that the export price is reported artificially high. As a basis for constructing the "true" export price, investigating authorities should look at the price of the imported product when first resold to an independent buyer. From this price, they may deduct "allowances for costs" incurred between import and resale and "for profits" (Article 2:4). This in turn increases the likelihood of a positive dumping margin.[195] In sum, even when an export price is readily available, investigating authorities can substitute it by a figure constructed in accordance with a set of vague guidelines.

Even more leeway for construction is provided with regard to the determination of normal value. Chart 5.4 shows how it is calculated according to Article 2:2.

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duty cases, the standard of review is provided for in Article 11 DSU. This standard is less deferential than the one in Article 17:6 of the Agreement on Antidumping, see GAO (2003). For a general discussion of the standards of review in WTO dispute resolution see Oesch (2003).

[193] *US – Antidumping Measures on Certain Hot-Rolled Steel Products From Japan*, WT/DS184/AB/R, Para. 55.

[194] For a comprehensive analysis of deference in antidumping cases see Durling (2003). Tarullo (2002) argues that the Appellate Body has essentially disregarded Article 17:6 thus far.

[195] The panel in *US – Antidumping Measures on Stainless Steel Plate in Coils and Stainless Steel Sheet and Strip from Korea*, WT/DS179/R, Para. 6.93, noted that "[...] a Member is not *required* to make allowance for costs and profits when constructing an export price." (Emphasis in the original.)

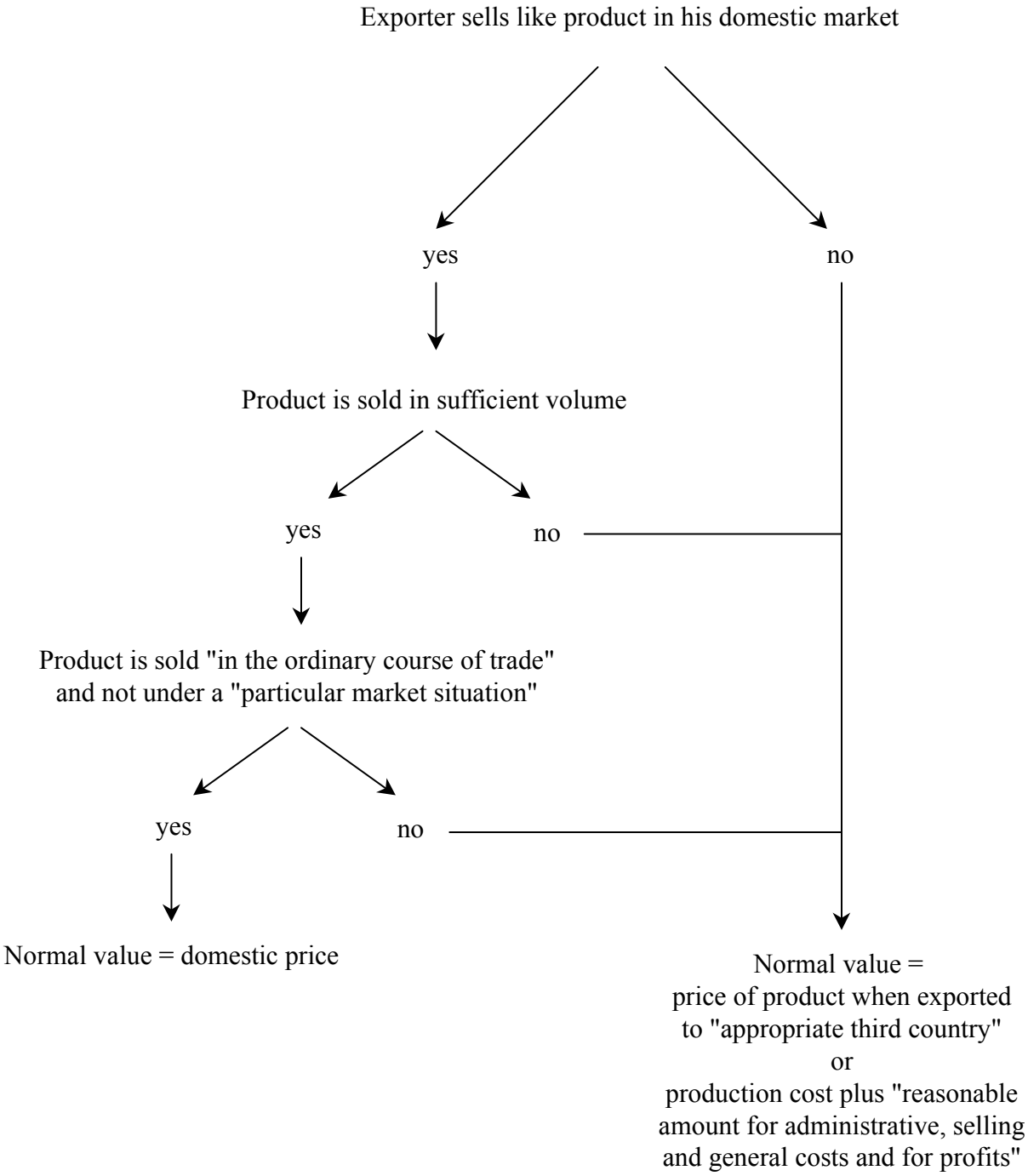

Chart 5.4: The determination of normal value[196]

Only when the exporter sells a like product in sufficient volume, "in the ordinary course of trade", and not under a "particular market situation" on his domestic market, is it sure that normal value will be based on an actual price. A sufficient volume requires that the respective sales constitute at least five percent of the sales to the country that is allegedly faced with dumping. The term "in the ordinary course of trade" is a euphemism for:

[196] In accordance with Article 2:2 of the Agreement on Antidumping.

covering at least unit production costs (fixed and variable) plus administrative, selling and general costs. If the exporter decided to sell on his domestic market below these costs during at least six months and in "substantial quantities", these sales could be disregarded from calculating normal value, even though it is perfectly rational from a business perspective not to charge fixed costs under certain circumstances.

The Agreement on Antidumping gives no guidance on the term "particular market situation". One could think of certain arm's length transactions between producer and distributor on the domestic market. They could lead to a low normal value if the latter were based on the price charged to the distributor, compromising the chance of finding a positive dumping margin. Therefore, investigating authorities regularly calculate normal value on the basis of the resale price to the first independent buyer. The Appellate Body in *Hot-Rolled Steel* accepted this practice, but noted that "[...] when investigating authorities decide to use downstream sales to independent buyers to calculate normal value, they come under a particular duty to ensure the fairness of the comparison [...]."[197]

When the methods for calculating export price and normal value are established, there is still the question of how to compare the two. Article 2:4 requests that a "fair comparison" is made. Fairness includes, *inter alia*, that the comparison is made "at the same level of trade" and "in respect of sales made at as nearly as possible the same time." Furthermore, export price and normal value should be compared either on an average-to-average or on a transaction-to-transaction basis. For example, an average normal value must not be compared with an export price derived from a single transaction where this transaction price happened to be particularly low. However, "[...] if the authorities find a pattern of export prices which differ significantly among different purchasers, regions or time periods [...]", an average normal value may nonetheless be compared to prices of individual export transactions. This exception allows for a form of the so-called "zeroing"-method: those export prices that are above the normal value (causing a negative dumping margin) can be eliminated from the dumping determination, i.e. a zero value can be attributed to them.

According to Article VI:1 GATT, antidumping is formally restricted to dumping that "[...] causes or threatens material injury to an established industry [...] or materially retards the

establishment of a domestic industry." Similar to the case of the Safeguard Clause, such an injury to the import-competing industry does not need to be balanced against any potential gains for other economic entities, such as consumers or users of foreign inputs. Article 3 of the Agreement on Antidumping provides guidelines regarding both material injury and the causation issue. Before concluding that material injury exists, the investigating authorities shall consider whether there has been[198]

(1) "a significant increase in dumped imports, either in absolute terms or relative to [domestic] production or consumption",

(2) "a significant price undercutting by dumped imports", or

(3) a significantly depressing effect on prices despite the absence of a significant price undercutting.

While an increase in dumped imports is an indication of injury, it is by no means a prerequisite for the application of antidumping measures, which is in marked contrast to the Safeguard Clause. This is confirmed by the last sentence of Article 3:2: none of the factors (i) to (iii) "[...] can necessarily give decisive guidance." In other words, none of the factors can become an *ex-ante* reason for the exclusion of antidumping action. When imports from more than one country are allegedly dumped, it is not necessary to isolate the individual effects of these imports for the purpose of determining injury. Instead, a so-called cumulation over countries may be applied: the imports from all these countries can be added up before the question of injury is answered.

Of course, injury itself cannot be measured in terms of rising imports or declining prices. Therefore, Article 3:4 provides a list of 15 factors that shall be evaluated in order to determine the negative impact of allegedly dumped imports on the import-competing industry. These factors include, *inter alia*, actual and potential declines in sales, profits, output, market share, productivity, return on investments, or utilisation of capacity; negative effects on cash flow, inventories, employment, wages, growth, and the ability to raise capital or investments. The Appellate Body confirmed in the *H-Beams* case the

[197] *US – Antidumping Measures on Certain Hot-Rolled Steel Products From Japan*, WT/DS184/AB/R, Para. 168.
[198] See Article 3:2.

"mandatory nature of the factors mentioned in Article 3:4."[199] All of them must be examined before injury is determined, yet – and this is of crucial importance – not all of them have to point in the same direction.

More guidance for investigating authorities is presumably provided when there is no claim of actual injury, but only of threat thereof (see Article 3:7). Firstly, the threat must be based on a change in circumstances which is "clearly foreseen and imminent". Secondly, all factors listed in Article 3:4 must be evaluated in the threat analysis.[200] Thirdly, additional factors should be considered, such as the likelihood of substantially increased imports, the free capacity of foreign exporters, or existing inventories of the product under investigation.

The Agreement on Antidumping includes an extensive body of procedural rules governing the antidumping investigation. It is not in the scope of this analysis to discuss all of them. Instead, I limit attention to a few elements of particular interest. Article 5 details the information which must be provided by an import-competing industry that considers itself to be injured by dumped imports before an investigation can start. The authorities have to examine the "accuracy and adequacy" of this information. If the investigating authorities determine that either the dumping margin is *de minimis* (i.e. less than two percent, expressed as a percentage of the export price) or the volume of dumped imports is "negligible" (i.e. less than three percent of all imports of the like product), the antidumping investigation shall "immediately" be terminated.

Article 6:12 requires that "[t]he authorities shall provide opportunities for industrial users of the product under investigation, and for representative consumer organisations in cases where the product is commonly sold at the retail level, to provide information [...]." This is, however, *not* a public interest clause that is intended to balance the interests of different economic entities regarding an antidumping measure. In particular, there is no provision stating what the authorities should do with this information, or to what extent it should be included in their decision-making process. Article 6:2 gives all interested parties the right to defend their interests. The term "interested party" includes the exporter

[199] *Thailand –Anti-dumping Duties on Angles, Shapes and Sections of Iron Non-Alloy Steel and H-Beams from Poland*, WT/DS122/AB/R, Para. 125.

[200] This requirement cannot be found explicitly in the Agreement on Antidumping, but has been pointed out by the panel in *Mexico – Anti-dumping Investigation of High Fructose Corn Syrup from the United States*, WT/DS132/R, Para. 7.127.

of the product under investigation and his government.[201] Any preliminary or final antidumping action must be notified to the WTO Committee on Antidumping Practices.[202]

* * *

With regard to the second category of criteria used in this analysis (form of protection), it is easy to verify that antidumping represents an inherently discriminatory instrument. In theory, it seems reasonable to apply antidumping duties only to those foreign exporters that actually dump their products. However, if one contends – as I will do later on – that antidumping is primarily used to push out the most competitive foreign producers from the domestic market, this selectivity loses its appeal: antidumping is then not only protectionist in nature, but its protective content also neglects the MFN principle.

Antidumping can occur in different forms. Firstly, Article 7 allows provisional measures in the form of a duty or a security "equal to the amount of the antidumping duty provisionally estimated". The duty must not exceed the (provisionally estimated) dumping margin. Secondly, an investigation may be suspended or terminated without the imposition of duties if the authorities and the exporter of the product in question agree on a "voluntary undertaking" that obliges the exporter to raise the export price (Article 8). Such an undertaking is only acceptable if the investigating authorities have already found that dumping, injury, and a causal relationship between them exist. In fact, Article 8 runs counter to the aim of banning VERs, which is stipulated by the Agreement on Safeguards. This creates a blatant inconsistency in the world trading order. Thirdly, a definitive antidumping duty can be imposed (Article 9). According to the "lesser duty" rule, the duty should be lower than the identified dumping margin, and only as high as necessary to avert injury to the import-competing industry. In the *Byrd Amendment* case, the Appellate Body ruled that the US practice of distributing the revenue from antidumping duties to the import-competing industry is incompatible with WTO rules.[203] Such a payment would not only increase the incentive of all import-competing sectors to call for antidumping action, but it would also create an unjustified competitive advantage relative to uninvolved third-country competitors.

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[201] See Article 6:11.
[202] See Article 16:4.
[203] See *US – Continued Dumping and Subsidy Offset Act 2000*, WT/DS217, 234/AB/R. The disputed US practice was based on the *Continued Dumping and Subsidy Offset Act* of 28 October 2000.

Since antidumping is a reaction to allegedly unfair behaviour of foreign exporters, there is neither compensation[204] nor a possibility of reciprocal suspension of concessions by the export country. Before establishing a request for compensation, it would be necessary to eliminate the unfair trading argument. However, this would deprive antidumping of its most important justification.

The Committee on Antidumping Practices provides members with the opportunity to consult on any matters relating to the operation of the Agreement (Article 16). Article 11 requests that "[a]n antidumping duty shall remain in force only as long as [...] necessary to counteract dumping which is causing injury." In contrast to the Safeguard Clause, there is no explicit time-frame by which the measure has to be terminated. However, there is a need for review (the so-called sunset clause) in maximum intervals of five years or upon request of an interested party "[...] which submits positive information substantiating the need for a review." In parallel with the lack of a compensation requirement, there is no case for adjustment of the import-competing industry, since import restrictions allegedly do not occur due to deficient competitiveness of the domestic industry, but due to unfair foreign trading practices.

Finally, there are no specific provisions for developing countries. Although Article 15 mentions their "special situation", an antidumping user need not adjust the measure when directing it against one of them. The (unofficial) reason for this is simple – and can be concluded from Chapter 3: antidumping has always been an instrument primarily devised to protect the markets of industrialised countries from cheap developing world products. From this perspective, it would be paradox to have an agreement that restricts the use of the instrument *vis-à-vis* developing country exports.

5.2.4 The main problems with antidumping

From a social welfare perspective, the trouble with the current use of antidumping is at least threefold. Firstly, as argued above, there is no economic rationale for antidumping action as long as dumped imports are not based on predatory intent. Such an intent is difficult to prove, but can be ruled out in most cases. For example, Shin (1998) analyses 282 antidumping investigations in the US between 1980 and 1989 with nonnegative

[204] For a more precise discussion of this argument see Chapter 6.

outcomes.[205] Only 39 of them can be upheld after consideration is given to market structures that are simply irreconcilable with monopolistic behaviour. These 14 percent of the sample would have to be examined further, searching *inter alia* for the existence of market entry barriers as another precondition for successful predatory practice. Messerlin (2001) does a similar exercise as Shin, but for the EC. He concludes that only two percent of 461 cases that were initiated between 1980 and 1997 are candidates for closer examination on predation grounds.[206]

Secondly, there is substantial evidence that antidumping is used even in the absence of any dumping. The leeway in the Uruguay Round Agreement and national antidumping laws make it possible to deviate from economically reasonable calculation methods. Lindsey (2000), for instance, concludes that current US law is incapable of reliably identifying either price discrimination or sales below cost: in sum, antidumping has little to do with dumping. As Finger and Zlate (2003, p. 2) note, "[a]ntidumping is ordinary protection with a good public relations program".[207]

Thirdly, current antidumping practice can create a paradox situation: although ultimately intended to secure competition at home, there are indications that antidumping promotes collusive arrangements between firms (namely between foreign exporters and the import-competing industry).[208] One form of such arrangements, the voluntary undertaking, is explicitly recognised as a legitimate means of raising prices. Since it is the *threat* of an antidumping investigation that is often responsible for a collusive arrangement, numbers on the actual use of the instrument necessarily underestimate the negative impact of the current policy.

Summarising these findings, antidumping has lost its connection with unfair trade, whatever the precise meaning of unfair may be. It has become a standard device used for the protection of organised industries. Economic theory points out the consequences of such a trade distortion, and there is no doubt that the welfare loss exceeds the effects of definitive antidumping measures: Prusa (1999) calculates that antidumping duties cause

[205] Nonnegative outcomes consist of cases in which antidumping was eventually imposed and cases which were suspended or terminated. Cases with negative findings are excluded.
[206] In contrast to Shin, Messerlin's original dataset includes the cases with negative findings. This explains his lower percentage rate.
[207] Additional support for this claim can be found in Lindsey and Ikenson (2002).

the value of imports to fall by 30 to 50 percent on average, but that trade declines by almost as much in cases which have been settled. Furthermore, even negative findings of the responsible authorities cannot prevent a decrease in trade by 15 to 20 percent. Gallaway, Blonigen, and Flynn (1999) estimate the combined welfare loss of US antidumping and countervailing measures for the domestic economy to be almost four billion US dollars in 1993 alone. This amount does not include the effects of actions that have been threatened, but not implemented. However, whereas antidumping is condemned by most economists, the public does not seem to have recognised its negative impact on social welfare. In contrast, the argument of unfair trade, questionable as it might be, still meets with high response in the public debate of developed countries.

5.2.5 Existing suggestions for reform

The existing suggestions for reform are mostly based on the conviction that antidumping has been abused in the past, but that the concept as such is nonetheless a legitimate element of the world trading order. Consequently, they are not aimed at making the use of the instrument more expensive for the government by insisting on compensation.[209] Instead, they are intended to raise the level of prerequisites. This can be done by enriching the Agreement on Antidumping with rules that are better based on sound economics. Major suggestions in this respect focus on (1) the calculation of the dumping margin, (2) the inclusion of market structure analysis, and (3) the determination of injury. These three categories are now discussed in turn.

To begin with, the leeway in calculating the dumping margin could be reduced.[210] It has been recommended that when there are few or no domestic sales, normal value should mandatorily be calculated based on the price of exports to the largest third market. This suggestion is intended to provide the most reliable data, and more importantly, to avoid an arbitrary estimation of the exporter's production cost. Another proposal is to eliminate the

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[208] See Prusa (1992). Hindley and Messerlin (1996) and Messerlin (1990) provide further evidence for collusive strategies.

[209] At first, Bown (2002) is a notable exception. He suggests that antidumping users deposit all revenue into an escrow account. The distribution of these funds would then be determined by the WTO, based on the statutory acceptability of the measure imposed. Though this suggestion seems to combine antidumping with compensation, it in fact does not. Only those cases that are decided in favour of the exporter would lead to financial refunds. Compared to the overall number of antidumping cases, these instances would be rare – given that the substantive rules on antidumping remain unchanged. This claim is supported by the low complaint ratios for antidumping in Chapter 3.

[210] See Miranda, Torres, and Ruiz (1998) for a discussion.

exception to the requirement that price comparisons must be either on an average-to-average or on a transaction-to-transaction basis.[211] Overall, the construction of the dumping margin should be guided by a more intelligent comparison of export price and normal value. For this to be the case, it seems natural to suggest that identical products be used whenever possible, and that they not be taken from different stages of the distribution chain.[212]

A higher degree of sound economics would also be applied if antidumping measures were made dependent on positive findings that dumped imports have a negative impact on market structure. Such an impact can be ruled out whenever the relevant market shows a low level of concentration, since this indicates that the industry under investigation does not have positive economies of scale.[213] Inspired by this argument is the suggestion that the *de-minimis*-rule and the rule on negligible volume ought to be expanded.[214] Moreover, negligible volume should be based on market shares instead of import shares. The fear of monopolising tendencies is unfounded as long as investigated imports are small relative to overall market size.

Economic expertise could be applied more diligently when determining injury. Hoekman and Leidy (1989) suggest that the number of admissible indicators of injury be reduced, and that the threat of injury alone should not be a cause for antidumping action. Demonstrating that dumping and injury exist should not suffice to conclude that all injury is caused by dumping, nor is it appropriate to infer the level of injury from the amount of price undercutting, as regularly done in practice. Furthermore, a number of studies show how strongly the practice of cumulation has contributed to positive findings in antidumping investigations.[215] It has therefore been proposed that cumulation be eliminated or confined to cases in which evidence of collusion between exporters is at hand.[216] Dealing with the question of injury has inspired observers such as Finger (1998) to propose a "national interest clause",[217] which clearly goes beyond the hearing of interested parties provided for in the current Agreement. The clause would require a

[211] See Messerlin (2000).
[212] Didier (2001) provides detailed suggestions in this respect.
[213] See Shin (1998).
[214] See Messerlin (2000).
[215] See Prusa (1998), Tharakan, Greenaway and Tharakan (1998), or Hansen and Prusa (1996).
[216] See Didier (2001), Messerlin (2000), or Tharakan (1999).

comparison of any injury with the benefits for consumers and users of inputs arising from lower prices of dumped products.

5.3 Countervailing duties

5.3.1 The economics of subsidies and countervailing duties

Both subsidies and countervailing measures cause distortions in world trade, whereby the distortion by a subsidy depends on its effect on the marginal cost of the receiving firm. If a firm were granted a subsidy under condition of introducing higher environmental standards in its production process, there might not be any net-effect on marginal cost. Therefore, the firm's output would not rise, given a constant market price. If, however, a subsidy were able to reduce marginal cost, the firm would become artificially more competitive on the market place. This could have two consequences. Firstly, the firm increases its market share at home, possibly at the expense of imports, thereby reducing trade volumes. Secondly, the firm increases its share on a foreign market, at the expense of import-competing firms on this market or to the harm of exporters from third countries.

Although subsidies were excluded from the list of flexibility instruments in Chapter 2, a proper understanding of countervailing duties calls for a knowledge of the motives behind subsidies. This is a complex topic. In the following, attention is limited to those subsidies that are intended to raise the export volume of a country, at the expense of production in other countries. I call them export subsidies, although their payment need not be formally conditioned on an export activity.[218] It is the most controversial kind of subsidy, since it is regularly perceived as an outgrowth of a "beggar-thy-neighbour" policy.

I shall proceed in two steps. Firstly, motives for an export subsidy are analysed under a fixed world market price. In this case, there is no beggar-thy-neighbour behaviour, and a higher export volume of the subsidising country has no influence on the competitive position of foreign firms. Secondly, I turn to "strategic trade policy": subsidies are provided to a domestic sector in order to enable its firms to establish a dominant position on the world market by offering lower prices.

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[217] Synonymous would be a mandated "cost-benefit analysis" of antidumping measures, see Bronckers (1996).

[218] Example: a production subsidy in a sector with high export potential.

5.3.1.1 Subsidies: fixed world market price

The main reason for export subsidies under a fixed world market price are the presumed positive externalities of export activity. The argument is as follows: export production generates economic utility that cannot be internalised by the exporter since his revenue is restricted to the price in the sales contract. As a consequence, he does not produce enough from a social welfare perspective.[219] In order to induce him to increase production, the public must bear some of the production costs.

In reality, however, instances of measurable externalities in export production are rare. An alleged example is that the sector creates employment. A study that evaluates the employment effects of the German export promotion program starts with the following words:[220]

> The economic prosperity of Germany is strongly influenced by the integration into the international division of labour. The safety of a considerable part of jobs in Germany thanks to the export business [...] is indisputable.

There is no doubt: export promotion creates and safeguards employment. However, there is no reason to believe that the production for domestic markets is less capable of doing so. Furthermore, one must not forget that public support for any particular sector risks destroying employment *somewhere else* in the economy since this support raises the overall tax burden. It is surprising to observe that the above-mentioned study does not pay any attention to this fact.

5.3.1.2 Subsidies: strategic trade policy

The globalisation process of the recent past has led to the widespread perception that countries are in competition with each other, similar to firms. In this competition, every country attempts to emerge as the winner by adopting strategic trade policies.[221] Many economists have problems with this way of thinking: they understand relative productivity

[219] He produces until marginal cost equates the price of the export product. From a social perspective, it would be optimal to add some measure of social value to the market price of the product.
[220] Translated from Prognos (2000), p. 1.
[221] Strategic trade policy should be understood as the public funding for some export sectors. I do not analyse the selection process of these sectors, but assume that some are – for any reason – more eligible than others. Symptomatic for the thinking in competitive terms is Thurow (1992). For a critique see Krugman (1993).

as a variable that is overwhelmingly determined by domestic factors (such as education). Furthermore, they conceive trade as a process that is – without ifs and buts – in the interest of all participating countries. In sum, strategic trade policy is a controversial concept.

Assume an oligopolistic market structure along the lines of Brander and Spencer (1985). There are two countries (*a* and *b*) that both have one single firm (*A* and *B*). These firms produce a homogenous export product for a third country, where they are duopolists. There are increasing marginal costs without fixed costs, and this cost function belongs to the common knowledge of the two firms, just as the demand function does. The duopolists determine independently of each other which quantities they want to sell in the third country.[222]

Since an increased total sales volume reduces the market price, both firms include the expected output of the respective competitor in their optimisation calculus. If *A* increased its output, the marginal revenue of *B* would decrease at an unchanged production level. Therefore, it would be optimal for *B* to reduce its output.[223] Consequently, *A* could increase its market share at the expense of *B*, and this raises profits of *A* while reducing those of *B*.

It is obvious that the adjustment process described would be similar for *A* if *B* increased its output. Both firms are aware of this mechanism and know that, for any given output of the competitor, there is an optimal own output. Therefore, an equilibrium emerges in which both firms respond optimally to the output of the competitor. None of the two firms has an incentive to deviate from this equilibrium, since this would reduce its profit if the other duopolist did not adjust. Any respective threat would not be credible.

Here starts the subsidy argument: if *A* were able to count on an export subsidy, but *B* were not, *A*'s marginal cost would decrease. As a consequence, *A*'s optimal output level increases for any given output level of *B*. The announcement of an increased output is credible, because it is based on known public regulations. *B* has to reduce its output level.

[222] The described constellation is a *Cournot* oligopoly. Support for strategic trade policy in other market constellations comes from Feenstra (1986), Itoh and Kiyono (1987) and Gruenspecht (1988). My subsequent critique regarding the Brander-Spencer model is, however, also valid in these constellations.

If the subsequent rise in profits of *A* is higher than the amount of the subsidy, the latter would be beneficial from a social welfare perspective of country *a*.[224] There exist, however, many objections to such a simple conclusion. Firstly, prospects for higher profit (due to public support) regularly come along with rent-seeking activities by the respective industry, which are a waste of resources.[225] Secondly, any subsidy results in a higher tax burden that causes distortions not reflected in the amount of the tax ("dead weight loss"). Thirdly, it is not realistic in the above constellation that the government of country *b* does not react with a subsidy of its own.

If firm *B* could also count on an export subsidy, a new equilibrium would result in which both firms produce more than in the initial situation without any subsidy. Whether total profits of the two firms are higher than in the initial situation or not remains open. However, total output is higher than in the social optimum, and social welfare is necessarily reduced.[226] In conclusion, it is doubtful whether a social welfare case for strategic trade policy can be made.

5.3.1.3 Countervailing duties

The economic case for countervailing measures against (allegedly) subsidised imports stands on the same uncertain ground as does the economic case for antidumping. Whereas the preceding paragraphs have shown how awkward it is to find instances where an export subsidy is advantageous from a social welfare perspective of the subsidising country, a respective exercise with regard to countervailing duties is even more difficult. In theory, two reasons could justify countervailing measures. The first one is that export subsidies could be short-lived. In this case, they might cause painful adjustment in the import-competing industry, which would be reversed after the expiry of the export subsidy. Obviously, this argument is weak in the face of long-term subsidies. The second justification can be taken from the antidumping reasoning: if export subsidies were intended to create market power that is subsequently used to raise prices (i.e. if there were

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[223] In the optimum, the duopolists produce the quantity where marginal revenue equals marginal cost. In the presence of increasing marginal cost, a reduced marginal revenue calls for a reduced output.

[224] If the two firms do not compete in prices, but in quantities (*Bertrand* oligopoly), an export *tax* is optimal from a social welfare perspective, see Eaton and Grossman (1986).

[225] See the seminal contribution of Krueger (1974). In order to get a subsidy, it is rational for a firm to incur costs up to the point where these reach the amount of the subsidy (multiplied with the probability of award).

[226] For a formal proof see Brander and Spencer (1985), p. 95f.

predatory intent), there would be a case for countermeasures. However, just as in the case of dumping, there is little empirical support for the assumption of predatory intent.[227] On the other hand, countervailing duties can easily be abused for protectionist purposes.[228]

5.3.2 Historical background

For a long time, the world trading order had two different regimes for the regulation of subsidies on the one hand and countervailing measures against these subsidies on the other. This historical separation is still reflected in the GATT: while Article XVI deals with subsidies, Article VI concerns countervailing duties.

The rules on countervailing duties have undergone considerable change since 1947. The development must be seen in parallel to the changing rules regarding the provision of subsidies. Intuitively, one would suspect that a tendency towards stricter subsidy rules should be accompanied by a reduced leeway in the application of countervailing measures. In fact, this is exactly what has happened.

Article XVI GATT ("Subsidies") included in its original version only today's Paragraph 1, consisting of a notification requirement for a country in the case of a subsidy "[...] which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory [...]". In the GATT review session of 1955, four new paragraphs were added to the article. The most substantive one was Paragraph 4, applicable to non-primary products only, which requested the abolishment of export subsidies resulting "[...] in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." However, not all contracting parties were ready to adopt the declaration that implemented this paragraph: it became binding only for a few countries.

Article VI, dealing with countervailing duties, did not distinguish between different kinds of subsidies (i.e. export versus other subsidies, or primary versus non-primary products). Any subsidy could be countervailed, provided that it "[...] cause[d] or threaten[ed] material injury to an established domestic industry, or [was] such as to retard materially

[227] See Trebilcock and Howse (1999).
[228] See e.g. Neufeld (2001).

the establishment of a domestic industry." As a consequence of this passive approach, subsidies could be countervailed even when in perfect compliance with Article XVI.[229]

At the end of the Tokyo Round, a Subsidies Code was adopted.[230] It brought about important modifications. Its substantive obligations can be divided into two groups, which the literature (but not the Code itself) has often called "Track I" and "Track II".[231] Track I dealt with the imposition of countervailing duties. Two points are noteworthy. Firstly, countervailing duties were made contingent on the causation of material injury (Article 2). As mentioned above, this prerequisite had already been part of the original Article VI GATT. However, it had not been binding for the US, which had applied grandfather rights to Article VI.[232] Furthermore, the Code established criteria for the determination of material injury (Article 6). Secondly, neither were countervailing duties restrained to certain types of subsidies, nor did the Code make progress in defining what a subsidy actually is. As a consequence, the broad leeway in applying countervailing measures remained intact.

Track II tackled the legitimacy of subsidies. Firstly, it prohibited export subsidies for non-primary products, even if they did not lead to price differentials between export market and domestic market of the subsidising country (Article 9). Secondly, it contained for the first time disciplines on the use of "subsidies other than export subsidies" (Article 11). The literature (but again not the Code itself) has referred to them as "domestic" subsidies. The Code recognised that domestic subsidies can have effects on international trade (e.g. by reducing imports into the subsidising country). If these effects "[...] cause or threaten to cause [i] injury to a domestic industry of another signatory or [ii] serious prejudice to the interests of another signatory or [iii] may nullify or impair benefits accruing to another signatory [...]", contracting members should avoid the respective subsidies. If they refused, or if they granted export subsidies for non-primary products, consultations could be required (Article 12). If these consultations did not lead to a mutually acceptable solution, the Code would provide for a dispute settlement mechanism, including a panel process.[233] However, there was no mechanism to enforce a panel decision.

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[229] See Stehn (1996).
[230] See the *Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the GATT*.
[231] See e.g. Jackson (1997), p. 288,
[232] See Jackson (1997).
[233] See Article 13 and Part VI.

In the framework of the Uruguay Round, a new agreement was concluded. Jackson (1997, p. 290) calls it a "substantial change from the Tokyo Round Subsidies Code" and a "substantial improvement". Steger (2003, p. 1f) judges it to be "a masterful achievement" and continues to argue that "[i]t contains a delicate balance of subsidy definitions and disciplines that were intended to be clear, predictable and enforceable". In contrast to the Tokyo Round Code, the Uruguay Agreement on Subsidies and Countervailing Measures (thereafter the Agreement on Countervailing Measures) is mandatory for all WTO members.

5.3.3 Analysis

For the first time in the history of multilateral subsidy regulation, the term "subsidy" is comprehensively defined. Article 1:1 of the Agreement on Countervailing Measures states that[234]

> For the purpose of this Agreement, a subsidy shall be deemed to exist if:
>
> (a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:
>
> (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);
>
> (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
>
> (iii) a government provides goods or services other than general infrastructure, or purchases goods;
>
> (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government [...];
>
> or

[234] Footnote omitted.

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994;

and

(b) a benefit is thereby conferred.

According to the Appellate Body ruling in the *Aircraft* case, "[a] 'benefit' does not exist in the abstract, but must be received and enjoyed by a beneficiary or a recipient."[235] This means that a financial contribution that is simply inferred from the expenditure list of the government could not be called a subsidy if there were no evidence of a benefit to a firm. Furthermore, the Appellate Body stated that

> [...] the word "benefit", as used in Article 1:1(b), implies some kind of comparison. This must be so, for there can be no "benefit" to the recipient unless the "financial contribution" makes the recipient "better off" than it would otherwise have been, absent that contribution. In our view, the marketplace provides an appropriate basis for comparison in determining whether a "benefit" has been "conferred", because the trade-distorting potential of a "financial contribution" can be identified by determining whether the recipient has received a "financial contribution" on terms more favourable than those available to the recipient in the market.

In order to categorise subsidies in different groups (see below), the concept of specificity is introduced in Article 2 of the Agreement. When a subsidy is *de jure* or *de facto* limited to certain firms, it is specific. When there are objective criteria governing the eligibility for the subsidy, "[...] which are economic in nature and horizontal in application, such as number of employees or size of enterprise", the subsidy is non-specific.

Articles 3 to 9 of the Agreement group subsidies into prohibited, actionable and non-actionable subsidies. Subsidies that are contingent upon export performance or upon the use of domestic rather than imported inputs are prohibited. All non-specific subsidies are non-actionable. In addition, a variety of specific subsidies are non-actionable, provided that they meet some qualified criteria:[236] assistance (1) for research activities, (2) to

[235] *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, Para. 154-157.

[236] The list of criteria can be found in Article 8:2. According to Article 31 of the Agreement on Countervailing Measures, the provisions of Article 8 shall only apply for a period of five years, beginning with the date of entry into force of the WTO agreements, i.e. until 31 December 1999. The

disadvantaged regions, and (3) to promote the adaptation of existing facilities to new environmental requirements. These specific subsidies must be notified in advance in order to enable an examination of compliance with the criteria. The residual subsidies, e.g. those that are neither prohibited nor non-actionable, fall into the group of actionable subsidies. Most subsidies belong to this category.[237]

The categorisation in prohibited, actionable, and non-actionable subsidies is, *inter alia*, intended to determine the legitimate countermeasures. Just as in the Tokyo Round Subsidy Code, these are distinguished into countervailing duties (Track I) and the search for relief by means of a dispute settlement process (Track II).[238] Surprisingly enough, however, the categorisation has a limited impact on the use of the two tracks. This is particularly true with regard to Track I: the rules on countervailing duties, contained in Part V of the Agreement, nowhere refer to a difference between prohibited and actionable subsidies. It suffices that the subsidy, be it prohibited or actionable, causes or threatens material injury to a domestic industry. Non-actionable subsidies, however, are immune from challenge under Track I.[239] From an economist's perspective, the missing differentiation between prohibited and actionable subsidies is no tragedy: there is little rationale for countervailing action anyway. Furthermore, if there were indeed good reasons for such an action, it would generally not be the export-relatedness of a subsidy, but the subsidy's impact on the market structure of the importing country. Approximating the impact on market structure by the export-relatedness of a subsidy is definitely a suboptimal solution.

Under Track II, which has been used much less intensively than Track I since 1995,[240] there are again only minor differences between the three subsidy categories. Prohibited subsidies can be challenged even when there is no injury since the prohibition is

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Committee on Subsidies and Countervailing Measures should have reviewed the operation of the provision by that date, with a view to determining whether to extend its application, either as initially drafted or in a modified form. Thus far, no accord could be achieved, and the provision is therefore not in effect at the moment.

[237] See Jackson (1997).

[238] See e.g. Hauser and Schanz (1995), p. 95. Similar to the Tokyo Round Code, the Uruguay Agreement on Countervailing Measures itself does not mention the terms "Track I" and "Track II".

[239] This provision is hidden in Footnote 35 of the Agreement (referring to Article 10).

[240] See Steger (2003). The relationship between the number of countervailing measures and the number of panels established is thus far approximately 5:1.

absolute.[241] Actionable subsidies can be challenged when causing "adverse effects" to the interests of other members. These are (see Article 5) (i) material injury to a domestic industry of another member, (ii) nullification or impairment of benefits to other members accruing under the GATT, or (iii) "serious prejudice to the interests" of another member. Serious prejudice in turn is deemed to exist in the case of[242]

> (a) the total ad valorem subsidisation of a product exceeding 5 percent;
>
> (b) subsidies to cover operating losses sustained by an industry;
>
> (c) subsidies to cover operating losses sustained by an enterprise, other than one time measures [...]
>
> (d) direct forgiveness of debt [...]

In the case of serious prejudice, it is up to the subsidising country to prove that its behaviour does not have adverse effects. This shift of the burden of proof has been celebrated as one of the major achievements of the Agreement on Countervailing Measures.[243]

Non-actionable subsidies can be challenged when they cause "serious adverse effects" to the domestic industry of a member. Although it is not clear what the difference between adverse effects and serious adverse effects is, the qualification of adverse effects should obviously make the access to Track II somewhat more difficult in the case of non-actionable subsidies.

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[241] There is no compensation in the case of prohibited subsidies. This has been underlined in the aftermath to *Automotive Leather II*, where the panel initially argued otherwise and decided that a prohibited subsidy should be repaid retroactively. From the beginning, this decision was controversial. The two parties in the dispute (Australia and the US) finally ignored it and settled the case bilaterally. They agreed to a partial reimbursement, corresponding only to the amount not already spent by the beneficiary. Subsequent panels also chose not to follow the decision of the panel in *Automotive Leather II*. See *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21:5 of the DSU by the United States*, WT/DS126/RW. The bilateral settlement was notified on 31 July 2000, Document No. WT/DS126/11. For an analysis of the case and its implications see Goh and Ziegler (2003).

[242] Article 6:1. Footnotes omitted. According to Article 31, the provisions of this paragraph shall only apply for a period of five years, just as is the case with Article 8 discussed above. Thus far, no accord could be achieved in order to reinstate it, and the provision is therefore not applicable at the moment. Steger (2003) requests that the provision should be given effect again in the framework of the Doha Round.

[243] See, for example, Hauser and Schanz (1995).

While all subsidy categories can be challenged under Track II, the procedure is not exactly the same. In the case of prohibited and actionable subsidies, the matter is referred to the DSB, and the dispute settlement process in accordance with the DSU starts. However, some additional rules apply.[244] These first and foremost accelerate the process, particularly when a prohibited subsidy is at issue. For example, whereas the DSU requires that the period in which the panel conducts its examination shall not exceed six months,[245] the respective period under Track II of the Agreement on Countervailing Measures is 90 days in the case of a prohibited support and 120 days in the case of an actionable subsidy. As regards non-actionable subsidies, the dispute settlement process in accordance with the DSU is not available. However, a member who considers himself to be seriously adversely affected may – after having conducted consultations – refer the matter to the WTO Committee on Subsidies and Countervailing Measures.[246] The Committee can recommend a modification of the subsidy in question, and – if the recommendation is not followed – authorise the requesting member to take commensurate countermeasures.

* * *

The prerequisites for countervailing duties are basically the existence of a subsidy (as defined by Article 1), the demonstration of material injury, and a causal relationship between the two. Article 15 elaborates on the determination of injury and causal relationship. The respective rules are similar to those in an antidumping investigation.[247] Therefore, I do not address them here, but only emphasise once more the *de-minimis* clause in Article 11:9. This states that there shall be "[...] immediate termination [of the countervailing duties investigation] in cases where the amount of a subsidy is [less than one percent *ad valorem*], or where the volume of subsidised imports, actual or potential, or the injury, is negligible."

According to Article 13, allegedly subsidising governments must be invited for consultations before the initiation of an investigation. Article 12:10 requires that "[t]he authorities shall provide opportunities for industrial users of the product under

[244] See Articles 4 and 7 of the Agreement on Countervailing Measures.
[245] See Article 12:8 DSU.
[246] See Article 9. According to Article 31, the provisions of this Article shall only apply for a period of five years, just as is the case with Articles 6:1 and 8 discussed above. Thus far, no accord could be achieved in order to reinstate it, and the provision is therefore not applicable at the moment.
[247] This is confirmed by Jackson (1997), p. 279.

investigation, and for representative consumer organisations in cases where the product is commonly sold at the retail level, to provide information [...]." Again, this is not a public interest clause, and there is no provision stating what the authorities should do with this information. Finally, any preliminary or definitive countervailing action shall be reported "without delay" to the Committee on Subsidies and Countervailing Measures (Article 25:11).

Regarding the other criteria for analysis used in this chapter, there are once more strong similarities to antidumping:

(1) Countervailing duties are a selective instrument: they are applied only to those foreign exports that are (allegedly) subsidised.

(2) The countervailing duty instrument can occur in different forms. Firstly, Article 17 allows measures in the form of a provisional duty guaranteed by cash deposits or bonds "equal to the amount of the provisionally calculated amount of subsidisation". Secondly, an investigation may be suspended or terminated without the imposition of duties if the authorities and the exporter of the product in question agree on a "voluntary undertaking" that obliges the exporter to raise the export price (Article 18). Such an undertaking is only acceptable if the investigating authorities have already found on a preliminary basis that subsidy, injury, and a causal relationship between them exist. Thirdly, a definitive countervailing duty can be imposed (Article 19). No duty shall be levied "[...] in excess of the amount of the subsidy found to exist, calculated in terms of subsidisation per unit of subsidised and exported product."

(3) There is neither compensation, nor a possibility of reciprocal suspension of concessions by the subsidising country.[248]

(4) Article 21 of the Agreement provides that "[a] countervailing duty shall remain in force only as long as [...] necessary to counteract subsidisation which is causing injury." There is no explicit time-frame by which the measure has to be terminated.

[248] As further discussed in Chapter 6, some compensatory effects are present in cases where an investigation is terminated by a voluntary price undertaking, since rents are shifted to the foreign exporter by the rise of export prices. However, whenever investigations lead to definitive measures, there is no such effect any more.

However, there is a need for review (sunset clause) in maximum intervals of five years or upon request of an interested party "[...] which submits positive information substantiating the need for a review." There is no adjustment requirement for the import-competing industry, since protection presumably does not occur due to a lack of competitiveness.

(5) Special provisions for developing countries are included in Part VIII of the Agreement, yet they are only partly about countervailing duties. Paragraphs 7 to 9 make it more difficult to use Track II against developing country members. Article 27:10 provides that a countervailing duty investigation of a developing country product shall be terminated as soon as there is a determination that

(a) the overall level of subsidies granted upon the product in question does not exceed two percent of its value calculated on a per unit basis; or

(b) the volume of the subsidised imports represents less than four percent of the total imports of the like product in the importing member [...].[249]

In other words, developing countries benefit from a more generous *de-minimis* clause.

5.3.4 Existing suggestions for reform

The developments in the regulation of subsidies on the one hand and countervailing duties on the other hand have shown some notable parallels in the past. This has not been a historical accident, but the consequence of the strong interrelation between the two concepts. Just as with ordinary tariffs, the most appealing development with respect to the subsidy regime would be to intensify the negotiations on a reciprocal reduction. If these negotiations were successful, there should be less resistance to reforms on the use of countervailing duties. Since I am primarily concerned with the instrument of countervailing action here, I take a continuous process of subsidy reduction as given, without looking at its precise characteristics. Then, what could reforms to the current regime of countervailing duties look like? Diamond (1990) suggests a so-called

[249] This is valid "[...]unless imports from developing country Members whose individual shares of total imports represent less than four percent collectively account for more than nine percent of the total imports of the like product in the importing Member" (Article 27:10(b)).

entitlement approach. Under this approach, countervailing measures would be contingent on more than the existence of a benefit described in today's Article 1 of the Agreement on Countervailing Measures: the benefit would have to result in a reduction of the exporter's marginal cost of production. Only if such a reduction were present, would competition be in danger of being distorted. The problem with this suggestion is the lack of useful data. Firms do not keep appropriate records on marginal costs, and even if they did, their interpretation would be difficult due to divergent national standards.

Trebilcock and Howse (1999) have two different strands of suggestion. The first one is their "first best" solution. It consists of disciplining countervailing duties by subjecting them to the stricter regime for safeguard measures in accordance with Article XIX GATT. This would mean, for example, that the *increase* of subsidised imports becomes a prerequisite. Furthermore, there would have to be serious instead of material injury. The "second best" solution, in contrast, would maintain the leeway in applying countervailing duties, but would allow them only in the case of a narrow class of prohibited subsidies. Just as under the first-best solution, this would result in higher overall prerequisites for the application of countervailing measures.[250]

5.4 The violation of WTO agreements

The violation of WTO agreements is not a conventional flexibility instrument. Violations are illegal, and they have consequences for the international reputation of a WTO member. These consequences represent costs, and the use of the violation instrument is therefore more "expensive" than a simple look at compensation requirements and/or retaliatory suspension of concessions would suggest. Kovenock and Thursby (1992, p. 160) acknowledge these reputation costs and ascribe them to the breach of "international obligation". They argue that "[...] we can think of this disutility as a loss of goodwill in the international arena or the political embarrassment that comes from being suspected of violation [...]."

[250] The introduction of higher prerequisites has also been suggested by the EC. For example, it has pushed for making the "lesser duty" rule mandatory. The rule is encouraged in Article 19:2 of the Agreement on Countervailing Measures, but is not mandatory thus far. Furthermore, there should be a greater implementation of public interest tests in countervailing duty cases. See the *International Trade Reporter*, Vol. 19, No. 46, 21 November 2002. Support for the EC position comes from Canada, see the *International Trade Reporter*, Vol. 20, No. 8, 20 February 2003.

Apart from its unique effect on international reputation, which is difficult to quantify, the violation instrument shares important characteristics with lawful flexibility instruments. It is therefore a potential substitute for the latter. In particular, it is a trade policy tool that enables a government to raise the level of import restrictions. In accordance with my definition of trade policy flexibility, it is exclusively this import-restricting possibility that is of interest to me: I do not look at violations that have other motives, such as, for example, the promotion of exports.

When analysing violations, the approach must differ to a certain extent from the one used in the preceding subsections. The analyses of Safeguard Clause, antidumping, and countervailing duties have been of a "direct" nature in the sense that the WTO agreements include rules that prescribe how to apply these instruments. This has become most obvious in the extensive discussion of prerequisites, but also of the form of protection (remember the selectivity issue). Violations, in contrast, do not have prerequisites, and there is no restriction with regard to the form of protection. In general, there are no rules that specify the use of the instrument. Therefore, an "indirect" approach for analysis must be applied: given that a violation has been committed, the analysis must focus on its *consequences* for the violator. These consequences, in turn, have an influence on how the violation instrument is used in the first place.

5.4.1 Historical background and recent problems

The origins of the multilateral dispute settlement in trade affairs date back to the unsuccessful establishment of an International Trade Organisation (ITO) and the subsequent conclusion of the GATT.[251] The ITO would have contained an ambitious, institutionalised dispute settlement process, with the possibility of appeal to the planned World Court in certain circumstances.[252] In contrast, the GATT initially disposed of few and rather vague dispute settlement guidelines, namely Articles XXII and XXIII. The resulting process in the years thereafter may be called "diplomatic" in that it was not based on (1) independent adjudication or (2) written procedures. Attempts to eliminate the first flaw were already made during the fifties, when expert panels replaced the so-called working parties. The latter had been composed of representatives from individual member

[251] For a comprehensive description and analysis of the dispute settlement history, see Jackson (2001, 1998, 1998a, 1997), Hudec (1999, 1993), or Trebilcock and Howse (1999).

states, who were subject to governments' directives. The second shortcoming was partly cured by an understanding of the Tokyo Round,[253] which laid down a comprehensive description of dispute settlement procedures applied in former GATT cases. This increased the degree of legalisation in the dispute settlement process during the eighties. However, the understanding did not only codify norms, it also "[...] Balkanised the procedures by recognising different modes of dispute resolution for different elements of the GATT."[254]

With the conclusion of the new DSU as part of the Uruguay Round, the *right* to a panel decision was established, depriving a potential defendant from blocking the adjudication process. Furthermore, a permanent Appellate Body was installed. It enables the parties to appeal a panel ruling and contributes to the consistency of legal interpretation of WTO agreements. Last but not least, there is now an almost unified process for disputes under all agreements.

Though there seems to be a widespread consensus that the DSU mechanism is a useful tool for settling disputes,[255] a significant number of problems have been identified in the past few years. To begin with, it is doubtful that developing countries have equal opportunities to enforce their rights. While there are encouraging signs that the mechanism is not a forum where the strong prevail over the weak (see Chapter 3), at least some developing countries lack the resources for bringing a case or for defending themselves appropriately. Furthermore, their retaliation threat is limited due to their small demand on world markets.

Secondly, a few of the decisions have been criticised for their sole emphasis on promoting trade liberalisation, ignoring in particular environmental concerns. In the *Shrimp/Turtle* case, the US was condemned for restricting imports of shrimp on "process and production methods" (PPMs) grounds.[256] While this provoked an outcry of environmentalists, the ruling was not directed against the US commitment for the environment *per se*, but against a procedural aspect: the US discriminated among imports of shrimp that were

[252] See Jackson (1998). The Charter for the ITO included an entire chapter on the "Settlement of Disputes".
[253] See the *Understanding Regarding Notification, Consultation, Dispute Settlement and Surveillance*, adopted on 28 November 1979, Document No. L/4907.
[254] Barfield (2001), p. 25.
[255] See Guzman (2003), Footnote 2, for a few references supporting this claim.

caught by the same method. The Appellate Body did not answer the question of what would have happened in the case of a non-discriminatory import restriction, an outcome which was interpreted by some commentators as an implicit recognition of environmental concerns.[257] However, this could be wishful thinking. Sampson (2000) writes:

> Can WTO obligations be breached to ensure that certain standards deemed appropriate by the importing country are applied in the exporting country as a precondition for doing business? Much to the chagrin of many environmentalists, the traditional interpretation has been that trade measures related to environmental standards should be taken only with respect to the fauna and flora and natural resources within the boundaries of the country taking action. The implications are clear. Countries are free to adopt whatever regulations they wish to reflect standards *within their own borders*, but they cannot restrict trade on the grounds that other countries do not apply these standards domestically. In practical terms, this means that while a country may adopt whatever fishing practices for tuna or shrimp it wishes to protect dolphins, turtles, or any sea life, *it cannot refuse to import tuna or shrimp from countries that choose not to adopt the same or equivalent standards*.[258]

Thirdly, as briefly outlined in Chapter 2, there is a fear of excessive and activist law-making by panels and the Appellate Body. A prominent example is the treatment of *Amicus Curiae Briefs* in dispute settlement procedures. There is broad opposition from many member countries against the use of such submissions in the multilateral adjudication process.[259] Despite this opposition, the Appellate Body ruled in various cases in favour of accepting these submissions.[260] The right of the panel was based on Article 13 DSU, and the Appellate Body considered itself in a position to accept *Amicus Curiae*

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[256] See *US – Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58.
[257] See Barfield (2001).
[258] p. 110. Emphasis added.
[259] The main argument is that such submissions are primarily made by powerful organisations that could thereby influence panels and the Appellate Body to promote their private motives.
[260] See *US – Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58, but also *US – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, WT/DS138, and *EC – Measures Affecting Asbestos and Asbestos-Containing Products,* WT/DS135.

Briefs when it is "pertinent and useful" to do so.[261] Barfield (2001, p. 45) argues that the Appellate Body has indulged in "judicial creativity" in this case.[262]

Fourthly, the exact nature of settlement (i.e. the economic impact) is unknown in various cases and possibly not in accordance with WTO agreements. Zimmermann (2001) identifies the risk that the contents of a settlement are regularly not in the interest of third parties. This would be the case when the settlement consists of a modification of the disputed measure that satisfies the particular demands of the complainant, but that is not intended to further the general market access in the respective sector. In the *Periodicals Case*,[263] for example, Zimmermann points to the fact that some market opening occurred in areas that were not subject to the multilateral dispute at all.

However, the most important problems are apparently those related to disputed implementation of DSB rulings. Although the DSU sets a time-frame and urges the losing defendant to comply, there have been numerous delays, conflicts about interpretation of the text (especially as to the relationship between Articles 21:5 and 22 DSU), threats of trade wars, and high-profile cases of outright non-compliance.

5.4.2 Analysis

5.4.2.1 Rule-orientation

When analysing the systemic implications of violations, observers often refer to the significance of "rule-orientation" among member countries. For example, critics who complain about the failure of dispute settlement with regard to the prevention of violations regularly argue that the level of rule-orientation is too low. They suggest that the best way of coping with such problems is to strengthen the obligation of DSB rulings.

I propose to distinguish two aspects of rule-orientation. The first one is relevant whenever a WTO member alleges that a violation has occurred. In this case, someone has to determine whether the allegation is true. Such an adjudication does not only give

[261] *US – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, WT/DS138/AB/R, Para. 42.

[262] Sampson (2000), p. 114, cites the view of a number of countries arguing that "[t]he Appellate Body had diminished the rights of members and intruded upon members' prerogatives as negotiators to establish the bounds of participation in the WTO. Such issues should be decided by members." The potential costs of this judicial activism are discussed in Tarullo (2002).

[263] See *Canada – Certain Measures Concerning Periodicals*, WT/DS31.

guidance on what is "right" or "wrong", it also influences *ex post* the distribution of member rights. In this context, rule-orientation would have to be contrasted with power-orientation.[264] The latter predicts that adjudication results in a solution reflecting the difference in power of the countries. The more powerful country is expected to attain a more favourable outcome *ceteris paribus*. In contrast, the rule-oriented determination makes reference to rules and procedures previously agreed upon, is based on the equality of countries, and would include impartial third-party arbitration. It is argued that such a rule-orientation has continuously gained support over time, notably due to a more and more legalistic dispute settlement process. While the prevailing perception well into the eighties was that "GATT dispute resolution should not be particularly formal",[265] there is not much left from diplomatic dispute resolution since the conclusion of the Uruguay Round.[266]

The second aspect of rule-orientation takes the determination of a violation as given and deals with the nature of remedial action. In the WTO context, it concerns the implementation of a DSB ruling, and therefore the legal effect of an adopted panel (or Appellate Body) report. Under the rule-oriented perspective, such a ruling creates an

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[264] The comparative use of the two terms "power-orientation" and "rule-orientation" dates back to Jackson (1978).

[265] Shell (1995), pp. 856f.

[266] Weiler (2000), p. 7ff, argues – in wonderful language – that much of the new legal culture is at odds with the ethos of traditional diplomacy of the pre-Uruguay-Round history. Examples are:
(1) "Legal disputes which go to adjudication are not settled, [but] they are won and lost. The headlines talk of 'victory' and 'defeat'."
(2) "[...] when two parties believe the law is on their side and decide to litigate, [this] becomes a profession of passion, of rhetoric, of a desire to win, [which is] all inimical to compromise." According to Weiler, there have been only few cases in the history of the WTO (e.g. *EC – Measures Affecting Butter Products*, WT/DS72, or *EC – Trade Description of Scallops*, WT/DS12 and 14) in which a compromise could be found once a Panel had started its work.
(3) "A huge factor in the decision whether to go for legal resolution will have been the conscious and often subconscious input by lawyers driven by ambition and their particular professional deformations. The 'we can win in court…' becomes in the hands of all too many lawyers an almost automatic trigger to 'we should bring the case'. Surgeons like to operate: they have been trained to do that. Lawyers like to litigate and win cases."
(4) "[There] are [...] inevitable changes in the DSU process itself brought about by jurisprudence such as the ruling in *Banana III* [*EC – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27] which allowed Member States to employ private lawyers in their litigation, and in *Turtle* [*US – Import Prohibition of Certain Shrimp and Shrimp Products*, WT/DS58] and *Asbestos* [*EC – Measures Affecting Asbestos and Products*, WT/DS135], which opened up the process to amici briefs. Both decisions (on legal representation and amici) offended some of the very diplomatic reflexes [...] since they contradicted the internal, the discrete and the intergovernmental nature of disputes as perceived by many delegations. And yet in both decisions the Appellate Body was doing no more than most conservative and prudent courts would do to ensure the integrity and fairness of legal process."

international legal obligation upon disputing parties to carry out the decision of the DSB. A losing defendant is obliged to "specific performance" as regards the recommendations adopted. Jackson (1997a) examines the DSU and finds at least eleven clauses that presumably support this rule-orientation.[267] An opposite view would be that the losing defendant has free choice between specific performance, offering of concessions in other areas (i.e. trade compensation), or acceptance of retaliation in the form of suspension of concessions by affected parties.[268] The second aspect of rule-orientation is accordingly not contrasted with power-orientation, but with freedom in implementation.

In my opinion, it is this second aspect that stands at the forefront of academic discussion today.[269] It is indeed an open question as to what extent members of the WTO should be guided by rule-orientation when implementing a DSB ruling. My study does not contribute anything new to this debate, but emphasises two insights that seem to be of particular relevance. Firstly, rule-orientation *is* the preferable way for implementing a ruling. The DSU states in Article 22:1 that "[...] neither compensation nor the suspension of concessions or other obligations is preferred to full implementation of a recommendation to bring a measure into conformity with the covered agreements." However, a "preference" leaves room for alternative solutions: it cannot be interpreted as an *obligation* to go ahead in a particular way.[270] Secondly, when talking about freedom of implementation, I have in mind trade policy flexibility – i.e. a temporary rise of import restrictions, not a permanent one. If the DSU created an obligation to specific performance in the long run, this could not be read as excluding a *temporary* choice against it.[271] In essence, the DSU implicitly recognises the fact that the violation of WTO agreements is part of the institutional design of trade policy flexibility. Therefore, the main function of the DSU is to determine if a violation has happened and to establish the price that has to be paid by the violator (re-balancing). The price includes negative

[267] The international-legal-obligation view is also supported by McBride (2001).
[268] See Schwartz and Sykes (2002), Sykes (2000), or Bello (1996).
[269] This is not to say that there is no debate about the first aspect of rule-orientation. Barfield (2001), for example, argues that "[...] the WTO will have to adopt a less rigid, more flexible dispute settlement system, one that does not promise a 'correct' legal answer to every problem" (p. 13). See the discussion in Subsection 5.4.3.
[270] See Sykes (2000).
[271] Even John H. Jackson, who supports a strong rule-orientation in the WTO, recognises "the fact that the members did not desire perfect compliance" with the WTO's primary obligations when signing the agreements. On the other hand, he argues that "this does not mean that they wanted only the degree of compliance that the remedies they agreed to would produce", see Vázques and Jackson (2002), p. 564.

reputational consequences. The credibility and competence of the dispute settlement process are, however, a precondition for such reputational effects.

Article 3:2 DSU states that the dispute settlement system of the WTO should "[...] clarify the existing provisions of [the] agreements in accordance with customary rules of interpretation of public international law." However, starting from the empirical fact that the DSB has almost always supported the complainant,[272] the dispute settlement process does not seem to be so much about *clarification*, but rather about *confirmation* of a violation. Clarification would involve interpreting the law. The complainant might ask the adjudication body "Am I right?". The dispute settlement process would be "a monitoring device that distinguishe[s] between true deviations [...] and mistaken perceptions [...] that such a deviation has occurred."[273] Confirmation, in contrast, involves informing third parties on an actual violation. In this case, the complainant would request the adjudication body to "tell the world" about the illegal behaviour of the defendant. This is particularly important for weak countries. Maggi (1999, p. 210), supporting my claim that this is the proper understanding of the DSU, writes that "[...] weak countries invoked the [dispute settlement process] to inform the whole trading community of the GATT-illegal policies, and the strong countries complied with the GATT panel for fear of loss of reputation in the GATT arena."

The innovations of the DSU have reinforced the purported function of the dispute settlement. Firstly, the defendant cannot block a ruling any more: there is no possibility of avoiding the confirmation of a violation and the determination of a price for it. On the other hand, it is now explicitly excluded that this function is undertaken by a national authority. As Article 23:2 DSU formulates, "[m]embers shall not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired [...], except through recourse to [the WTO] dispute settlement." As past requests for authorisation of suspension of concessions show, members that have been negatively affected by a violation tend to (strategically) exaggerate the nullification or impairment incurred.[274]

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[272] See Chapter 3.

[273] This is how Kovenock and Thursby (1992), p. 167, describe its role.

[274] In the *Bananas* case (WT/DS27), for example, the US calculated the level of nullification or impairment to be 520 million USD, compared with 191 million USD authorised by the DSB. In the *Hormones* case (WT/DS26,48), the numbers were 202 and 117 million USD, respectively.

Secondly, the complainant now has substantial agenda-setting power.[275] Together with a tight time-frame for the work of panels and the Appellate Body, this ensures that the confirmation of a violation and the subsequent price-setting are not unduly delayed. This reduces the time of free-riding. Thirdly, the possibility of an appellate review makes sure that the confirmation of a violation is based on an accurate and reliable assessment. This does not only increase the predictability of rulings, but is especially important for a successful impact on reputation. If rulings were based on an arbitrary determination, the reputation of the (losing) defendant would barely be affected.

5.4.2.2 Two casual observations regarding the dispute settlement

Two observations are further evidence that members of the WTO have had in mind the establishment of an institutional design in which the violation of WTO agreements is not made impossible, but serves as an instrument providing trade policy flexibility. The first observation is that bilateral negotiations to find a mutually acceptable solution are *de jure* and *de facto* the preferred tool for the settlement of disputes. If trade policy flexibility were to be excluded, there would be nothing to negotiate: the disputed restriction would simply have to be immediately revoked. The second observation is that when bilateral negotiations fail and the defendant refuses specific performance, there is only a limited enforcement effort.

As to the first observation, the DSU requires that bilateral negotiations take place before and during the formal dispute settlement process. Such negotiations apparently are a desirable feature, yet I suggest that the desirability of bilateral negotiations does not end at the moment of a DSB ruling. If a mutually acceptable solution "is clearly to be preferred" (Article 3:7 DSU), there is no logical argument that invalidates this statement for the time after a DSB ruling has been rendered. In fact, only the negotiation in the aftermath of a ruling can profit from an improved balance of bargaining positions due to the assignment of costs to the (losing) defendant by the DSB.

The DSU requires in Paragraphs 5 and 6 of Article 3 that any solution found in bilateral negotiations shall be consistent with the WTO agreements and be notified to the DSB. However, even in cases where bilateral solutions are properly notified and in principle consistent with the agreements, the level of import restrictions need not yet reach its

[275] See Bütler and Hauser (2000).

original (lower) level: defendants are regularly tempted to keep the substance of an initial violation, but to find an arrangement which somehow circumvents WTO rules and is therefore difficult to challenge. Although one might think that this is equally true for bilateral settlements before *and* after a DSB ruling, it is plausible to assume that the transparency of a solution is significantly higher in the second case: a DSB ruling does not only alter bargaining positions, it also directs public attention to the dispute. The more "problems" arise with the implementation of a ruling, the more certain it is that the media are carefully tracking any attempt of *rapprochement* between the parties. An eventual settlement that comes after a DSB ruling may therefore be closer to the rules than a more or less unnoticed deal in the consultation stage of dispute settlement.

The second observation is the low level of enforcement efforts in the WTO. It is important to distinguish two aspects of this observation. One is that there has always been a *natural* limitation of enforcement efforts: as argued in Chapter 4, sovereign countries cannot be forced to behave in a particular way as long as drastic measures remain excluded. However, this does not mean that any enforcement effort is useless, and this brings me to the second aspect: countries can consciously create *artificial* limits of enforcement that are (far) below the natural limits.

What leads to the conclusion that the natural potential for enforcement is not exploited in the WTO? A first indication is that panels and the Appellate Body regularly refrain from suggesting specific implementation measures. Although they are allowed to formulate such suggestions,[276] they rarely go beyond "standard recommendations". Three points follow immediately. Firstly, defendants are not discouraged to maintain at least part of the protective element of their initial violation.[277] Secondly, due to the lack of guidance, any implementation is delayed. Thirdly, the final determination whether compliance has occurred needs greater scrutiny.

Enforcement is further weakened by the limited suspension of concessions that the DSB allows in the case of non-compliance (Article 22 DSU). As predicted by the adjusted

[276] Article 19:1 DSU provides that: "In addition to its recommendations, the panel or Appellate Body may suggest ways in which the Member concerned could implement the recommendations."

[277] Horn and Mavroidis (1999), p. 13, argue that: "When limiting themselves to recommendations, WTO adjudicating bodies give ample discretion to the losing party. WTO Members are then, in principle, free to adopt any conduct they deem necessary in order to bring their measures in conformity with their international obligations."

Ethier model in Chapter 4, the only function of such a suspension is restoring the balance of market access concessions.[278] Enforcement by far misses the maximum thinkable level: only the complainant is allowed to retaliate, and there are restrictions as regards the choice of sectors for retaliation. Furthermore, the costs of suspended concessions for the violator are presumably far below the discounted value of future co-operation determined in Chapter 4. This discounted value could be approximated by today's political value of membership. Since non-compliance is never punished with the denial of membership, the signatories of the WTO agreements (or of the GATT, respectively) consciously created artificial limits of enforcement.

5.4.2.3 The fairytale of trade wars

Problems with implementation in general and cases of non-compliance in particular have apparently increased in recent years.[279] Three reasons for this development come to my mind. Firstly, the broader coverage of WTO agreements and larger membership induce more disputes and thereby more cases of implementation problems. Secondly, the low number of non-compliance cases before 1995 is at least partly explained by the possibility of the defendant to block a negative outcome at various stages of the (old) dispute settlement process. It could be argued that such a blocking was a form of early non-compliance with an expected unfavourable ruling. Thirdly, the (often cited) increased confidence in the working of the new dispute settlement mechanism[280] can be interpreted as a growing recognition of its flexibility aspects: governments realise that the comprehensive agreements of the Uruguay Round have restricted their trade policy

[278] This view is confirmed by Palmeter and Alexandrov (2002). Admittedly, it is not unanimously supported. Charnovitz (2003) lists a broad variety of statements from WTO observers who recognise that the suspension of concessions should be considered as a "sanction" that is intended to induce compliance. Furthermore, he refers to two recent arbitration decisions according to Article 22:6 DSU. In the *FSC* case, the panel argued that "countermeasures are taken against non-compliance, and thus [the] authorisation [of the complaining Member to take them] by the DSB is *aimed at inducing or securing compliance* with the DSB's recommendation" (WT/DS108/ARB, Para. 5.52, emphasis added). In *Canada – Export Credits and Loan Guarantees for Regional Aircraft*, the panel went even further to state that "we consider that countermeasures are there to contribute to the end of a breach. We also believe that the 'appropriate' level of countermeasures should reflect the specific purpose of countermeasures. Keeping this in mind, 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" (WT/DS222/ARB, Para 3.107).

[279] See Pauwelyn (2000).

[280] See e.g. Bütler and Hauser (2000).

independence, yet that there is a dispute settlement process that allows them to "buy" some trade policy flexibility and "pay" a properly determined price for it.

Some recent disputes have received enormous publicity, and this is particularly true for some transatlantic quarrels, since the US and the EC are the most important trading partners on the globe. For some observers, the situation is so critical that two conclusions play a prominent role among them. The first one claims that the world is undergoing a series of transatlantic trade wars.[281] This view is nurtured by aggressive speeches of politicians and the tendency to use the word "sanction" when talking about the suspension of concessions authorised by the DSB. The second conclusion focuses on the specific role of the WTO in these conflicts and suggests that its credibility is severely at risk due to the alleged failure to settle the disputes.

I mistrust these conclusions. I argue that despite the fact that various analysts constantly predict the outbreak of notable trade wars, such a development has never been observable. The origins of important transatlantic disputes (such as *Bananas*, *Hormones*, or *FSC*) date back at least to the eighties. Nonetheless, they could neither impede the two most powerful members of the WTO from successfully concluding the Uruguay Round, nor did they deter them from launching a new round of liberalisation in Doha in November 2001. More importantly, bilateral trade volumes grew rapidly during the years of alleged trade war, as Chart 5.5 documents. EC merchandise exports to the US almost tripled between 1989 and 2002, whereas EC merchandise imports from the US doubled. Both the US-share in EC exports and the US-share in EC imports fluctuated in a range between 18 and 25 percent. It would be difficult to take this data as evidence that the bilateral trade relationship has been malfunctioning or deteriorating.

[281] Actually, the fear of transatlantic trade wars is a recurring feature in the history of international trade relations. Remember, for example, the agitation that surrounded the "Chicken War" in the sixties as reaction to the EC withdrawal of concessions in the process of forming a new Community tariff. See Evans (1971), pp. 173-80.

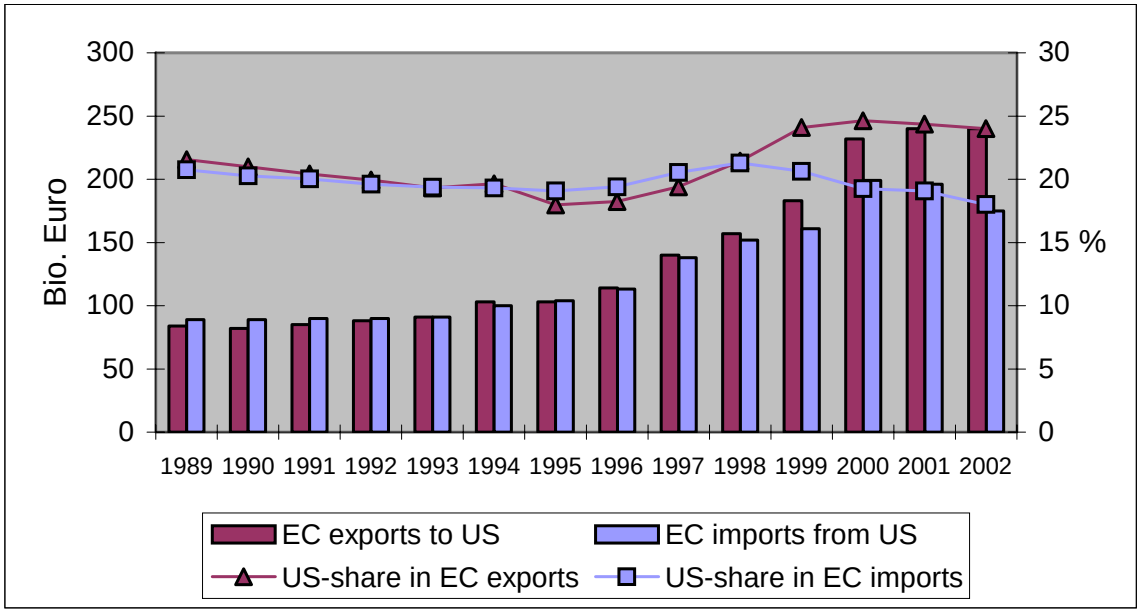

Chart 5.5: Bilateral merchandise trade between the US and the EC 1989-2002[282]

5.4.3 Existing suggestions for reform

Already within the framework of the Uruguay Round, it was decided to start a review process of the DSU. This process should have been completed by 1999, and a decision whether or not to modify the Understanding should have followed. However, the review is still under way, and no decision has been taken thus far.

The range of proposals for reform is broad.[283] Many suggestions have found their way into the *Balás* text, which is a compromise document resulting from DSU negotiations in the aftermath of the Ministerial Conference in Doha in November 2001.[284] It has been unclear up to now to which extent this text can be a basis for future reform. The only matter that seems to be uncontested is that there are indeed some inherent weaknesses in the DSU that deserve further attention. For the purposes of this study, the existing suggestions for reform can broadly be grouped into two categories. On the one hand, there are proposals that are intended to streamline the procedure which leads to a decision of the DSB. On the other hand, suggestions with regard to implementation have been brought forward. I shall discuss both categories in turn.

[282] Data source: Eurostat (2003).
[283] For a brief overview see Hauser and Zimmermann (2003) and Zimmermann (2003).
[284] See the *Report by the Chairman of the Special Session of the DSB, Ambassador Péter Balás, to the Trade Negotiations Committee*, dated 6 June 2003, Document No. TN/DS/9.

The path leading to a decision of the DSB has various steps. Unsuccessful bilateral consultations are followed by a panel procedure, and if the panel report is not acceptable to one of the parties (or to both), it can be appealed. After the Appellate Body has issued a recommendation, the DSB finally decides upon its adoption. Now, there have been suggestions to increase the professionalisation of the panel procedure by appointing a permanent Panel Body.[285] The main advantages would stem from time saving due to the elimination of the composition phase and from more experienced panellists. More professionalisation in the Appellate Body procedure could be achieved by appointing full-time members.[286] Furthermore, the Appellate Body could be provided with a remand authority, i.e. with the right to send back a case to the panel for additional factual findings.[287] Again, this could save time and avoid *de-novo* decisions that do not benefit from appeal. An increase in professionalisation might also be achieved by giving *Amicus Curiae Briefs* formal access to panels and the Appellate Body. The question of how to treat such *Briefs* is not explicitly answered in the current DSU. As already mentioned, the Appellate Body has developed a practice stating that the *Briefs* may, but need not, be respected in the determination of the case at hand.

A completely different direction for reform is followed by Barfield (2001), whose aim is not a professionalisation of procedures, but the extension of member control. As outlined in Chapter 2, he wants the dispute settlement to return to the tradition of diplomacy, which was prevalent in the pre-Uruguay-Round days. His considerations have experienced repercussions in a co-sponsored proposal by the US and Chile.[288] *Inter alia*, it envisages the possibility of a deletion of findings from Appellate Body reports and for a suspension of panel and Appellate Body procedures, both by mutual agreement among the disputing parties.

While the suggestions towards more professionalisation would probably not have any systemic implication, increased member control could have fundamental consequences on the world trading order. The principle of impartial third-party arbitration would be impaired. More member control would represent a return to power-orientation in trade

[285] A broad discussion has been offered by a *Mini-Symposium on the Desirability of a WTO Permanent Panel Body*. Its results are published in Vol. 6, No. 1 (March 2003) of the *Journal of International Economic Law*.
[286] See Ehlermann (2002).
[287] See Palmeter (1998).
[288] See Documents No. TN/DS/W/28, 23 December 2002, and TN/DS/W/52, 14 March 2003.

affairs. Remember once again the crucial difference between Barfield's member control and my understanding of trade policy flexibility: while the latter is perfectly reconcilable with a set of rules that govern the implementation of temporary import restrictions, the former would indeed bear comparison with a regime where everything is "up for grabs".[289]

* * *

The second category of reform proposals starts with the decision of the DSB and focuses on the implementation of (and the potential non-compliance with) such a ruling. A key topic for reform is the so-called sequencing issue.[290] When a complainant is not satisfied with the defendant's implementation of a DSB decision, the DSU envisages the following steps: (1) recourse to a compliance panel (Article 21:5), (2) request for authorisation from the DSB to suspend concessions, preceded by negotiations on compensation (Article 22:2), (3) request for an arbitrator to determine the level of suspension of concessions (Article 22:6). While all these steps make sense individually, the DSU is not clear-cut as regards their sequence. Is it necessary to have a compliance panel determine non-compliance before an authorisation for retaliation can be requested? What is the relationship between the compliance panel and the arbitrator, who himself is able to determine non-compliance? The *Balás* text contains an elaborate solution to these problems, inspired by past bilateral agreements between disputing parties. In essence, the text establishes that the compliance panel necessarily precedes any request for an authorisation of suspension of concessions. Furthermore, the panel report can be appealed. However, when the compliance panel (or, subsequently, the Appellate Body) concludes that the defendant has failed to comply, no additional period of time for implementation is conceded before an authorisation for retaliation can be requested.

Numerous interesting suggestions concern compensation. Three dimensions can be distinguished. Firstly, compensation could become a more prominent feature in the case of non-compliance. Secondly, it could be monetary. Thirdly, it might have a retroactive effect.

[289] I owe the pronounced statement in this context to Volker Rittberger.
[290] For an analysis see Rhodes (2000) and Valles and McGivern (2000).

As regards the first dimension, compensation is not at all foreclosed by today's DSU. However, it is voluntary (Article 22:1), and there is little incentive for the defendant to seriously negotiate on it. Matters would change if compensation were made "compulsory and automatic".[291] It could replace or complement the ordinary suspension of concessions.[292] In order to make negotiations on compensation less burdensome in a dispute, Lawrence (2003) proposes that each WTO member *pre-selects* a set of market access concessions that could be offered to negatively-affected parties when necessary. Such a selection would create "liberalisation security deposits". These deposits could have limited sectoral coverage, or represent prior commitments to make across-the-board cuts in barriers to trade. When a violation has been committed, the complainant would be authorised to choose a package of concessions from these security deposits. Lindsey, Griswold, Groombridge and Lukas (1999) propose the following (related) arrangement of mandatory compensation: any country refusing to implement a DSB ruling would have to present three alternative compensation offers, each envisaging liberalisation equivalent in commercial value to the initial violation. The complainant would be entitled to choose one of these alternatives. He could reject all of them, but only on the ground that they are not of sufficient value. In this case, the matter would be referred to independent arbitration.

Monetary transfers are suggested as a means of compensation to those who are *directly* affected by an illegal import restriction: the foreign exporters of the product in question. Note that direct *trade* compensation is not possible, since this would counteract the initial temporary protection: only non-affected exporters can be beneficiaries of compensatory market access concessions. Monetary compensation for negatively-affected exporters could therefore be a precondition for the latter to diligently report any trade barriers detected that are not in accordance with WTO rules. If this reporting were missing, many violations might never come to the attention of the respective government.[293] According to Pauwelyn, monetary compensation would also be easier to monitor and "more accessible for weaker WTO members" (p. 346).[294]

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[291] Pauwelyn (2000), p. 345f.

[292] This is supported, among others, by Barfield (2001), the *Trans-Atlantic Business Dialogue* (see the "Cincinnati Recommendations" at the occasion of its Conference in Cincinnati, November 2000), and the *Melzer Commission* on international financial institutions (see its "International Financial Institutions Advisory Commission Report", March 2000).

[293] I owe this argument to Thomas Cottier.

[294] Monetary compensation is also supported by Barfield (2001), Charnovitz (2001), and Bhagwati (1999).

The third dimension with regard to the increased importance of compensation concerns retroactivity. While difficult to operationalise, retroactive compensation would assure reparation for past damage, and therefore reduce the incentive to violate WTO agreements. An interesting proposal in this regard has come from Mexico.[295] Thus far, violations are avenged, but there are only reputational effects that would prevent a potential violator from free-riding on an illegal import restriction until the DSB has authorised a suspension of concessions – which can take up to three years.

In addition to compensation, retaliation is the subject of a variety of reform proposals. Interestingly enough, these suggestions are in general not for an increased admissible level of retaliation, but for making sure that the available level of retaliation[296] can effectively be made use of. This in turn is a primary concern of developing countries, who often do not have the ability to suspend concessions in accordance with the rules of the DSU without inflicting serious negative consequences on the domestic economy.[297] Therefore, it has been suggested that developing countries should be allowed to retaliate collectively, even if only some of them are negatively affected by the violation.[298] Since the suspension of trade concessions is itself trade-distorting, it has been proposed to replace it by other means of retaliation. For example, certain membership rights, including the use of the dispute settlement process or the participation in new negotiations, could be suspended.[299]

[295] See Document No. TN/DS/W/23, at No. II(b) (Mexico), dated 4 November 2002.

[296] The level is determined by the equivalence to the level of nullification or impairment (Article 22:4 DSU).

[297] According to Article 22:3, concessions shall be suspended with respect to the same sector(s) as that in which the DSB has found a violation. If it is not practicable or effective to do so, concessions in other sectors under the same agreement can be suspended. Only if this is again not practicable or effective, *and if the circumstances are serious enough*, the suspension may relate to concessions under another agreement covered.

[298] See e.g. South Centre (1999) or Vàzquez and Jackson (2002). Another proposal in this respect comes from Bagwell, Mavroidis and Staiger (2003). They analyse the possibility that retaliation is made "tradeable" and that retaliation rights are allocated through auctions.

[299] See Charnovitz (2002, 2001) or Lindsey, Griswold, Groombridge and Lukas (1999).

6 A New Direction for Reform

An important objective of this study is the analysis of the current institutional design of flexibility in the world trading order. The preceding chapter made a significant step in this direction by portraying individual flexibility instruments, based on the rules provided for in the WTO agreements. For the purpose of a static description, the insights of Chapter 5 might be sufficient.

However, the ambitious aim of formulating suggestions for future reform requires more than an isolated study of individual instruments. As outlined in Chapter 2, there is a certain degree of substitutability between them. Substitutability implies that if the rules on one instrument were modified, effects should also be observable with respect to other instruments. These effects could be unintended, and indeed undesired. They could go so far as to undermine the entire reform effort. Therefore, any serious discussion of reform must start from a *comparative* assessment of all flexibility instruments, which allows taking into consideration any concomitant developments at the time of redesigning individual instruments. The first section of this chapter is dedicated to such a comparative study.

Based on its results, which also demonstrate the weaknesses of existing suggestions for reform, a comprehensive proposal for a new institutional design is made in Section 6.2. This proposal differs from existing suggestions by shifting the focus from raising the level of prerequisites to an introduction of compensation as the natural counterpart of temporary protection. This re-orientation is intended to reduce the number of temporary import restrictions, while trade policy flexibility remains unimpaired.

6.1 A comparative study of flexibility instruments

6.1.1 Criteria selection

In Chapter 5, the four flexibility instruments were analysed according to an extensive set of predefined criteria. Chart 6.1 provides a schematic recapitulation of the individual analyses.

Category	Criteria	Safeguard Clause	Antidumping	Counterwailing measures	Violations
Preliminary stage	Prerequisites	yes	yes	yes	no
	Investigation	yes	yes	yes	no
	Notification	yes	yes	yes	no
	Consultation	yes	yes	yes	no
Form of protection	Selective Application	limited	yes	yes	yes
	Measure	tariff or quota	tariff	tariff	no constraint
Balancing	Compensation	yes	no	no	no
	Suspension	yes	no	no	yes
Control	Surveillance	yes	yes	yes	limited
	Limited duration	yes	yes in principle	yes in principle	no
	Review	yes	yes	yes	no
	Adjustment	no	no	no	no
Developing Countries	Special Provisions	limited	no	limited	no

Chart 6.1: A schematic recapitulation of results derived from Chapter 5

For the purpose of a comparative study of flexibility instruments, attention will be limited to only two criteria: prerequisites and compensation. I will argue that they are capable of establishing the basis for

(1) isolating the main deficiencies of the current institutional design of trade policy flexibility in the world trading order;

(2) defining a useful common denominator for many existing suggestions intended as a reform of individual flexibility instruments;

(3) identifying the weaknesses of these existing suggestions;

(4) proposing and evaluating an alternative solution for the reform of the current design of flexibility.

To focus on prerequisites and compensation is not to deny that the other criteria of Chapter 5 also play a role. Their neglect in my comparative analysis has in fact two reasons, which are now discussed in turn. Firstly, there is little disagreement among economists about the "optimal" design of flexibility instruments with regard to most of them. This is in contrast to prerequisites and compensation, where the conclusions from economic efficiency considerations are ambiguous. Secondly, while prerequisites and compensation are decisively shaping the design of trade policy flexibility, the other criteria do not crucially affect it.

6.1.1.1 The economists' advice with respect to individual criteria

For some criteria, the current institutional design corresponds well to what economists (almost) unanimously advise. Take, for example, the criteria that are related to transparency. Economic efficiency requires a high degree of transparency regarding the conditions that govern the cross-border exchange of goods. The rules on safeguards, antidumping and countervailing duties all include elaborate guidelines on notification, consultation, surveillance, and review.[300] While some observers criticise the easiness with

[300] As regards the violation instrument, transparency is limited. However, this is not due to a conscious accord among WTO members, but due to the inherent nature of violations, which are denied as long as possible.

which a temporary import restriction can be realised, these guidelines ensure that all trading partners are properly (and at an early stage) informed about a respective measure.

For other criteria, the current design does not (yet) correspond to what economists suggest, but the latter are at least at one with each other. Here, the selectivity issue is a good example. All flexibility instruments – even the Safeguard Clause under certain circumstances – provide for a discriminatory application of temporary import restrictions, i.e. against a limited number of exporters. This selectivity is in conflict with economic efficiency, which condemns the discriminatory use of trade policy measures. The economists' advice is clear: given that there is an exogenous need for trade intervention, this intervention should not distort the relative competitiveness among individual foreign exporters.[301] A second example of unanimity among economists concerns the form of the protectionist measure: the Safeguard Clause (in contrast to antidumping and countervailing duties) explicitly permits the use of quantitative restrictions. Again, the advice is clear: given that there is a need for trade intervention, such an intervention should be based on a tariff measure, and not on a quota.[302]

The situation is different for the prerequisites and compensation criteria: the conclusions from economic efficiency considerations are ambiguous. There are prominent trade economists, such as Michael Finger, whose message is to raise the prerequisites for temporary protection – notably in the form of antidumping – without considering the systemic importance of trade policy flexibility.[303] Finger is supported by a stunning range of international trade lawyers, as shown in the preceding chapter. Popular is the related proposal to substitute antitrust for antidumping and countervailing measures.[304] Since antitrust rules are in general rather strict, this would again undermine trade policy flexibility. On the other hand, recent theoretical and empirical economic research emphasises the advantages of international trade agreements that are not intended to

[301] An extensive discussion of economic (and legal) rationales for non-discrimination is provided by Horn and Mavroidis (2001). Remember my argument in the preceding chapter that antidumping and countervailing measures are primarily used to push out the most competitive foreign producers from the domestic market, and not to remedy some kind of unfair trading, whatever the meaning of unfair is.

[302] Various reasons for this can be found in Hauser and Schanz (1995).

[303] See e.g. Finger, Ng and Wangchuk (2001) or Finger (1998, 1993). This position is close to repealing antidumping without substitution. Broude (2003) calls the proponents of such suggestions "The Abolitionists".

[304] This suggestion is discussed in more detail below.

unduly tie the hands of governments.[305] These agreements are more stable and easier to conclude *ex ante*. Furthermore, Bown (2002, p. 58) argues that "[g]iven the ingenuity of policymakers, drastic reform [of antidumping] will simply shift protection to some yet-to-be-dreamed up alternative that will likely be even worse than [antidumping] measures."

Disagreement among economists is also apparent with respect to compensation. While there is not much doubt that compensation is an effective means of preventing harmful free-riding, it is regularly neglected in existing suggestions for reform, with the exception of those suggestions that deal with the violation instrument.

6.1.1.2 The importance of prerequisites and compensation

The second reason for my exclusive focus on prerequisites and compensation in the comparative analysis is that the two criteria are decisively shaping the design of trade policy flexibility, while the other criteria do not crucially affect it. The prerequisites of an instrument for temporary protection are in fact the embodiment of trade policy flexibility. Remember that trade policy flexibility has been defined as the ability of the government to decide when to introduce temporary import restrictions after an international trade agreement has been concluded. If the prerequisites are low, the number of economic circumstances in which the instrument can be used is high. This in turn does not impair the decision-making competence of the government. If, however, the prerequisites are high, then the number of economic circumstances in which the instrument can be applied is low, and the government is constrained in its ability to decide when to protect an import-competing industry. Trade policy flexibility is depleted in this case.

The compensation criterion states if (and to what extent) the trading partners are indemnified for the loss incurred by the temporary import restriction. Protection harms domestic consumers (of finished and intermediate products) and foreign exporters. If the WTO provided for private rights, compensation would be owed to all of them. However, as argued in Chapter 2, the WTO does not presently acknowledge such rights. Private entities cannot challenge a temporary import restriction. Consequently, compensation is owed only to negatively-affected foreign countries as a whole, represented by their governments. It is regularly understood as an improved market access in sectors unrelated

[305] See, in particular, Ethier (2002), Fischer and Osorio (2002), Koremenos (2001), Rosendorff and Milner (2001), Rosendorff (2001), Downs and Rocke (1995), and my considerations in Chapter 4.

to the temporary protection.[306] Full compensation would consist of market access concessions that maintain the overall balance and the level of concessions that existed among multilateral trading partners before the introduction of temporary protection.

Why is the compensation criterion essential for the institutional design of trade policy flexibility? At first glance, the ability to decide when to introduce temporary import restrictions is not affected by a claim for indemnity: compensation has nothing to do with a prerequisite according to my definition. On the other hand, compensation is after all the price of trade policy flexibility. While this price does not impair the autonomy of the government, it crucially influences its willingness to engage in trade intervention.

Note that the suspension of concessions is the last resort in the case that compensation is not offered. Although there are critics who do not only emphasise the inefficiency properties of suspensive action, but also doubt its effectiveness,[307] Chapter 4 underlined its importance for the self-enforcement of contracts. Both concepts, compensation and the suspension of concessions, help to balance the level of concessions among trading partners, but the institutional design of flexibility should – whenever possible – set priority to the provision of compensation.

Let me continue by looking at those criteria that presumably do not have a crucial impact on trade policy flexibility. The investigation, notification and consultation procedures do not influence the decision-making authority of the government as long as they do not provide third parties with a right to impede the decision or to unduly postpone it. This is not the case with regard to the flexibility instruments considered here: while the procedures help to clarify the issue, create transparency, and offer opportunities for interested parties to present their views, the government remains the exclusive entity in charge of making a final decision.

As regards the two criteria in the category "form of protection" (selective application, nature of the measure), they have played an important part in the history of the multilateral trading order. Remember from the preceding chapter the longstanding debate about selectivity in Safeguard Clause actions, which has been the origin of numerous

[306] See in particular Article 8:1 of the Agreement on Safeguards, which explicitly uses the term "trade compensation".

[307] The inefficiency is caused by the introduction of additional trade barriers. The ineffectiveness is inferred from the historical experience with the suspension of concessions. See e.g. Charnovitz (2002).

controversies among trading nations. By introducing temporary import restrictions, governments intend to protect import-competing industries. While everyone knows about the negative welfare effects of protection, the discussion of flexibility implicitly recognises the need for a system in which this temporary protection is not made impossible. However, a corollary to this recognition can – and should – be that a given level of protection brings about as little distortion as possible: trade policy flexibility, as I understand it, should not override basic pillars of the world trading system. Notably, it should be subordinated to the MFN Clause and to the elimination of quantitative restrictions. Both principles do *not* impair the ability of the government to protect an import-competing industry at any time – as long as this protection is provided by means of tariffs and on a non-discriminatory basis. An optimal institutional design of flexibility should therefore combine the right to temporary protection with the mandatory use of non-discriminatory tariffs.

The criteria in the "control" category (surveillance, limited duration, review, compulsory adjustment) do not stand at the core of trade policy flexibility since they cannot influence the government's ability to impose temporary import restrictions. However, by qualifying the course of protection *after* a respective decision by the government has been made, they are not without relevance: it would be useless to consider the rules that define the design of flexibility if there were no possibility of verifying that the actual use of flexibility is in accordance with these rules. The multilateral surveillance of temporary protection must be ensured. Indeed, all flexibility instruments discussed in this study are kept under surveillance.[308]

Duration is limited for measures under the Safeguard Clause, and investigating authorities have to provide good reasons when they extend antidumping or countervailing measures after an initial period of five years. The reasoning must be based on a comprehensive review that analyses whether the continued imposition of a duty is necessary to offset injurious effects of dumping or subsidisation.[309] Limiting the duration of a flexibility

[308] As to the violation of an agreement, this is true as soon as the violation has been detected and as long as the parties to the dispute do not decide to leave the multilateral level by exclusively searching for a bilateral settlement.

[309] Actually, there are suggestions to set a maximum time period for antidumping measures which cannot be extended even in the case of a comprehensive review. See a proposal of the "Friends of Antidumping Negotiations", cited in the *Bridges Weekly Trade News Digest*, Vol. 7, No. 11, 26 March 2003. The US dismissed the proposal.

instrument ensures that it is used for the purpose of temporary protection, and not as a tool for a permanent change of market access concessions. However, it is hard to determine *ex ante* the appropriate time-frame for temporary protection. The review mechanism confronts this problem by enabling an *ex-post* decision. However, as discussed in more detail below, there is an alternative means of limiting the duration of import restrictions, which is not based on an explicit time-frame: a progressive increase in compensation over time. This increase is intended to influence the incentive structure of the government so that the latter does not want to unduly extend the measure. It is immediately clear that only such an alternative means would be effective in view of violations: no one would suggest declaring violations of WTO agreements as illegal, but at the same time prescribing a maximum duration for them. If the duration of violations were to be restricted, the only starting-point could be the government incentive structure.

Remember from Chart 6.1 that no flexibility instrument includes compulsory adjustment. The reason is evident with respect to antidumping, countervailing measures, and violations. However, one may wonder why the text of the Safeguard Clause does not make more provision for ensuring a restructuring of the protected import-competing industry. On first inspection, the Clause is intended to promote economic efficiency by smoothing the impact of international trade on import-competing industries. Going more deeply into the text, however, the reader notes that there is neither an obligation for adjustment nor any indication of how such adjustment could be brought about.

Yet this observation is actually neither surprising nor dramatic. It is not surprising because flexibility in the world trading order is primarily rooted in political necessities, and not in the need to maintain or restore economic efficiency (more on that below). Furthermore, the missing adjustment requirement is not at all dramatic: the structural adjustment argument for the Safeguard Clause has fewer merits on economic grounds than one might suppose. Firstly, as a matter of fact, the employment-displacement effects of liberalised trade are chronically exaggerated:[310] there is less to adjust than generally believed. Secondly, even in the hypothetical case of a strong need for adjustment, there are more efficient ways of supporting ailing industries than restricting imports.[311] Thirdly, the potential need for adjustment does not only arise because of growing trade volumes. It

[310] See Lawrence and Krugman (1993). Freeman (2003) shows that immigration, capital flows, and technology transfers have significantly more impact on labour markets than changes in trade policy.

could just as well be attributed to changing consumer tastes, technology bringing about new production methods, or environmental concerns causing more stringent national regulation. In all these cases, temporary import restrictions would ease the pressure on import-competing industries and allow a smoother adjustment. Thus, the question is: why should adjustment that has been necessitated by rising imports be a justification for safeguard measures, whereas adjustment caused by other factors is not?[312]

In sum, structural adjustment could be alleviated by other means than temporary import restrictions, and such restrictions are not even a particularly useful instrument for that purpose. As a consequence, the optimal design of flexibility can be achieved without formulating respective requirements.

6.1.1.3 A developing country criterion?

The search for special provisions for developing country members with respect to flexibility instruments in Chapter 5 was not very successful. In theory, two different kinds of such provisions could be imagined. Firstly, the application of flexibility instruments could be made easier for developing countries, in particular by lowering the prerequisites for their use or by reducing any compensation requirement. Secondly, the application of such instruments *against* developing countries could be made more difficult, for instance by raising the prerequisites or by requiring more than full compensation. While the Agreement on Safeguards and the Agreement on Countervailing Measures provide a few minor provisions of the second kind, there is no provision of the first kind with regard to any flexibility instrument.[313]

Both kinds of special provisions are aimed at more favourable conditions for developing countries, as requested by many articles of the WTO agreements that call for "special and differential treatment". The GATT of 1947 made the favourable treatment of developing countries a core principle of the world trading order. Since then, numerous multilateral arrangements have been concluded, which should take into account their dismal

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[311] Production subsidies would be an example. They do not cause distortions on the consumption side.
[312] Jackson (1997), p. 176, has come up with this question.
[313] There is only one exception: if a developing country wants to use the safeguard instrument, it can extend the period of application beyond the maximum time admissible for developed countries, see Article 9 of the Agreement on Safeguards.

situation.[314] Based on Part IV of the GATT, introduced in 1965, and subsequently supported by the Enabling Clause of 1979,[315] the General System of Preferences (GSP) was established. Within its framework, developed countries have opened up their markets for developing country exports – independently of each other and in deviation from the MFN Clause. They have not requested a reciprocal market access in return.[316] The latest explicit reference to the needs of developing countries has originated in the Doha Round, which has been designated to be a "development round".[317]

Before commenting further on the special provisions in the context of flexibility, a few general words on the special-and-differential-treatment concept are warranted. Developing countries are in a difficult situation, as their standard of living is low. There is no doubt that their destiny merits increased attention and efforts to improve the current conditions. However, deducing from that a need for special treatment in trade affairs is not at all clear-cut. There are good arguments in favour of a world trading order that treats developed and developing countries alike and that emphasises instead the support of developing countries by measures that are not directly trade-related, such as capacity-building and technology transfer. On the other hand, there is a broad consensus among economists that developing countries should have more or less unlimited access to world markets. Respective requests are primarily directed against peak tariffs for products in which developing countries enjoy comparative advantages, and against tariff escalation.[318] However, such requests are not made in favour of differential treatment *per se*, but in favour of free markets. In other words, there is no genuine preference for deviations from reciprocity or for preferential treatment, but a recognition that political restraints make it

[314] For an overview of the elements of this favourable treatment and their historical evolution see Whalley (1999).

[315] See the Decision of 28 November 1979 on *Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries*, Document No. L/4903.

[316] For a critique regarding the effectiveness of the GSP see Roitinger (2001), UNCTAD (1998), or Davenport (1992).

[317] For a discussion of the development aspects in the Doha Ministerial Declaration see Hauser (2003, 2002) or Evenett (2003).

[318] Escalation is given when the tariff rate is positively correlated with the processing level of the import product. Such an escalation is a *sufficient*, but not a *necessary* condition for a discrimination of import products belonging to a higher processing level. This can be concluded from the empirical observation that the price elasticity of import demand increases with the processing level. It can be shown that even de-escalated tariffs are able to discriminate against imports from higher processing levels when the respective demand is strongly price sensitive, see Yeats (1984). For an evaluation of popular practices with respect to tariff escalation and peak tariffs in the context of developing country exports see UNCTAD (2000).

impossible to achieve free market access for developing country exports by alternative means, such as multilateral liberalisation. Under this perspective, differential treatment is an inferior solution, but it seems to be the only (politically) feasible one.

I do not contribute further to this debate here, but simply suggest that the first-best scenario for improving the conditions of developing countries would be to liberalise world markets on a non-discriminatory basis and to limit the special treatment to non-trade related activities. However, I admit that an improved access for developing countries on a non-reciprocal basis could be a useful initial step in the light of political restraints. In the spirit of this second-best solution, the institutional design of flexibility could complicate the application of flexibility instruments against developing countries, for instance by introducing or raising *de-minimis* clauses.[319] Alternatively, their application against least developed countries (LDCs) could be completely forbidden. Such a prohibition would barely impair the overall level of trade policy flexibility, since LDC exports are very small in relation to world exports, as Chart 6.2 reveals.

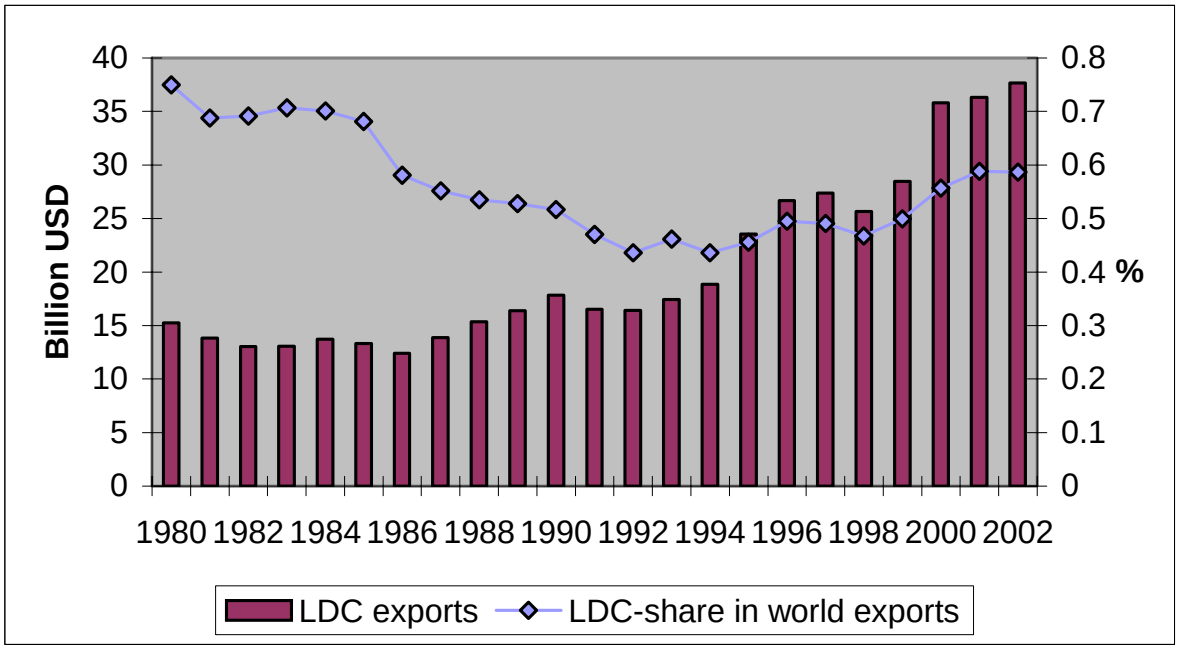

Chart 6.2: LDC exports: absolute and relative volume 1980-2002[320]

[319] Other requests in this regard, which have been brought forward by developing countries, include a moratorium on the initiation of new antidumping investigations within a year of the conclusion of an investigation on the same product, a mandatory imposition of the lesser duty rule, and a compulsory recognition of provisions calling for "constructive remedies" before applying antidumping against the exports of a developing country. See the *International Trade Reporter*, Vol. 19, No. 28, 11 July 2002.

[320] Data source: *International Trade Statistics 2002* of the WTO.

While LDC exports have more than doubled since 1980, their share in world exports has been oscillating between only 0.44 and 0.75 percent over the last twenty years.

However, neither the first-best (reciprocal free trade) nor the second-best solution (non-reciprocal free trade) would suggest an institutional design where the access to flexibility instruments is made easier for developing countries than for developed ones. As already mentioned, flexibility is primarily rooted in political requirements, not in the need to restore economic efficiency. Therefore, the economic differences between the developed and developing world – huge as they are – do not justify differential treatment with regard to the active application of flexibility instruments. In fact, this claim corresponds well with what can actually be observed today: since the relevance of Article XVIII.B GATT has been shrinking due to the advance of flexible currency regimes, developing countries have lost the only instrument for temporary import restrictions that had been specifically designed for them.

6.1.2 Locating the relative position of flexibility instruments

It has been claimed that prerequisites and compensation are useful and sufficient for analysing important questions with regard to the institutional design of flexibility. In this subsection, I will show how the two criteria can be applied in order to determine the relative positions of the four flexibility instruments according to their current design. Chart 6.3 employs prerequisites and compensation as two axes of a plane. The more distant is a point of the plane from the point of origin, the higher are the corresponding levels of prerequisites and/or compensation. Based on the analysis in Chapter 5, the circles show where the four flexibility instruments would roughly have to be located. The exercise of putting the instruments in relation to each other is admittedly coupled with some degree of arbitrariness. However, some good reasons should be found below on why Chart 6.3 provides a plausible picture. Furthermore, and this is important, my main argument will not focus on static positions, but on the dynamics of these positions in the context of (1) existing suggestions for reform, (2) actual multilateral negotiations, and (3) my alternative suggestion for reform. These dynamics can be analysed quite independently of the "true" current positions of the four instruments.

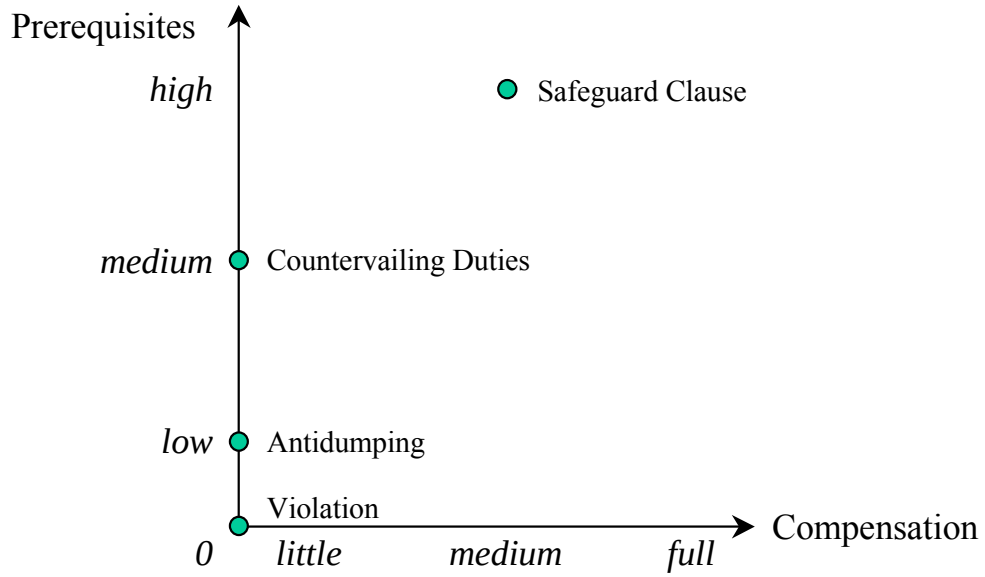

Chart 6.3: Locating flexibility instruments in the prerequisites-compensation plane

Look first at the compensation axis. Both antidumping and countervailing duties do not entail compensation, since they are allegedly based on unfair trade. Although the DSU emphasises the possibility of providing compensation in the case of a violation (Article 22), there is no corresponding obligation. Furthermore, the right for a suspension of concessions as an enforcement mechanism is postponed until the DSB has made a final decision on the case, making the request for compensation virtually ineffective for a considerable period of time. No retroactive compensation is envisaged. In sum, since I analyse violations as an instrument for *temporary* protection, they can be said to have no compensation dimension.

The use of the Safeguard Clause in principle requires full trade compensation. In addition, there is an immediate enforcement mechanism since the suspension of concessions (in the case of a failure to reach an accord on compensation) is possible soon after the introduction of temporary protection (see Article 8:3 of the Agreement on Safeguards). Still, there is the exception in the case of an absolute increase in imports, where the suspension is postponed for a three-year period, which can be read as a simultaneous suspension of the compensation requirement. On average, therefore, a medium level of compensation is required.

With regard to prerequisites, the classification is more burdensome, except for the violation instrument, which has no prerequisites. According to the Agreement on

Safeguards, measures may be applied if imports enter the country "[...] in such increased quantities, absolute or relative to domestic production, and under conditions as to cause or threaten to cause serious injury to domestic industry [...]."[321] In addition, Article XIX:1 GATT requires that the increase in imports is a result of both unforeseen developments and obligations incurred under the GATT. Antidumping is formally restricted to dumping that "[...] causes or threatens material injury to an established industry [...] or materially retards the establishment of a domestic industry."[322] It is difficult to judge the precise importance of these prerequisites and to properly uncover the respective differences between Safeguard Clause and antidumping. However, some observations are straightforward. Firstly, the use of a more stringent injury standard ("serious" instead of "material") is an obvious way of complicating the access to the Safeguard Clause relative to antidumping.[323] Secondly, the Safeguard Clause requires an increase in the import level, unforeseen developments, and an interrelation with obligations incurred under the GATT. None of these prerequisites can be found in antidumping provisions. Thirdly, only antidumping has a price component, as it requires that imports are dumped. However, this prerequisite can easily be constructed. In short, whereas no attempt has been made to precisely quantify the scale of prerequisites, the following conclusion is drawn: the level of prerequisites is substantially higher for the Safeguard Clause than for antidumping, and the level of prerequisites for antidumping is low.[324]

What about countervailing duties? I put them in a position between antidumping and the Safeguard Clause. Countervailing duties are similar to antidumping measures with regard to the prerequisites of injury and causal relationship. In particular, only material injury is required, just as in the case of antidumping, but in contrast to the more stringent injury standard of the Safeguard Clause. No increase in import levels, no unforeseen developments, and no interrelation with obligations incurred under the GATT are needed

[321] Article 2:1.
[322] Article VI:1 GATT.
[323] Stevenson (2003), p. 6, referring to the jurisprudence of panels and the Appellate Body, concludes that "[t]he 'serious injury' standard is very high, exacting a much higher standard of injury than the word 'material' (as used in antidumping)."
[324] Support for this conclusion comes from WTO case law. As Didier (2001) notes, recent decisions have both "watered down" the requirement of material injury and "emptied" the need for causality between dumping and injury (p. 34). Furthermore, an anecdote popular in Washington (and cited by Finger and Zlate 2003, p. 4) shows the easiness of getting antidumping protection compared to antitrust relief: An economist once asked a lawyer who represented an industry seeking antidumping protection why the industry did not search for antitrust relief instead. The lawyer answered: "Well, if you accuse someone of an antitrust violation, you have to prove it."

before a countervailing duty can be imposed. However, in spite of these observations that indicate a low level of prerequisites, they are higher than in the case of antidumping. The reason is the requirement that imports be subsidised before countervailing measures can be taken. The corresponding requirement for antidumping is that imports be dumped. Now, although the definition of a subsidy in accordance with Article 1 of the Agreement on Countervailing Measures is broad and also includes government revenue foregone or not collected, it is more difficult to demonstrate the existence of a subsidy than the existence of dumping.[325] Firstly, in contrast to an antidumping investigation, a countervailing duty investigation cannot merely cover the export industry, but must also include the subsidy regulations of the respective foreign government. This is politically sensitive, and more burdensome. Secondly, the subsidy calculation methods are less established than dumping calculations. As argued in the preceding chapter, the applied methods of proving dumping show considerable arbitrariness, but are broadly accepted because the Agreement on Antidumping explicitly provides for this discretion. Remember, for example, that normal value can be calculated in numerous cases by estimating the sum of production costs plus a "reasonable amount for administrative, selling and general costs and for profits". The Agreement on Countervailing Measures does not envisage such an *indirect* calculation method. There is no possibility of inferring a subsidy by simply comparing the export price with some sort of normal value.[326] In other words, the existence of a subsidy must be *directly* inferred.

* * *

One could be tempted to verify the relative positions of the four flexibility instruments in Chart 6.3 by looking at the empirical pattern of their use. The argument could be that an instrument with lower prerequisites and lower compensation requirements is expected to be applied more frequently. According to Chart 6.3, the expected ranking[327] would be (1) violation, (2) antidumping, (3) countervailing duty, (4) Safeguard Clause. An inspection of the numbers presented in Chapter 3 shows, however, that this expectation is not necessarily reconcilable with empirical facts. While the empirics support the dominance of antidumping over countervailing duties and the Safeguard Clause, they are less conclusive with respect to the relative ranking of countervailing measures and the

[325] See Stevenson (2003).
[326] Note that the term "normal value" does not even exist in the Agreement on Countervailing Measures.

Safeguard Clause and regarding the relative ranking of violations and all other instruments. There are two different ways of explaining possible discrepancies. The first one goes back to the notion that Chart 6.3 is not meant to be incontestable: I might have got it wrong. However, such a pessimistic conclusion need not be drawn. Potential discrepancies could also be explained if Chart 6.3 were absolutely accurate:

(1) The fact that the prerequisites of an instrument are high means that the *ex-ante* probability of fulfilling them is low. *Ex post*, however, the fulfilment might have been possible more often than expected. This can explain why the use of an instrument with high prerequisites exceeds the use of an instrument with lower prerequisites in some observation periods.

(2) With regard to compensation, the medium level assigned to the Safeguard Clause does not mean that compensation is *always* higher than for the other three instruments. When there is an absolute increase in imports and when the temporary import restriction is terminated no later than after three years, compensation is not owed. In some observation periods, an absolute increase in imports might have been the rule rather than the exception.

(3) As to violations, two specific remarks concerning the numbers in Chapter 3 should be repeated. Firstly, in contrast to the other flexibility instruments, they are illegal. This should have a restrictive effect on the use of the instrument, explaining that the numbers are possibly lower than expected from Chart 6.3. The second remark starts from the fact that violations are not notified by the violator. A violation is revealed only when someone is negatively affected *and* subsequently initiates a dispute settlement procedure, instead of searching an early bilateral settlement. As a consequence, the number of actual violations is higher than reported in Chapter 3.

(4) Corresponding to the second remark in (3), the numbers in Chapter 3 for antidumping, countervailing measures and the Safeguard Clause can be assumed to be too high. If a government notified, for example, a measure under Article XIX GATT, Chapter 3 would count it as a safeguard action. However, the temporary protection could actually be a violation. This violation might be uncovered one day, or it might not. There is evidence that many measures of the recent wave in

[327] Starting with the instrument that is used most frequently.

Safeguard Clause action are indeed inconsistent with WTO rules.[328] Furthermore, all safeguard measures assessed thus far by a panel or the Appellate Body have been found to be illegal.[329]

While these considerations can help to overcome potential discrepancies between Chart 6.3 and the numbers presented in Chapter 3, another point should be mentioned, which distorts the picture to a certain extent. A safeguard measure is mostly less selective than antidumping or countervailing duties since it covers more than one export country. Therefore, more than one antidumping/countervailing duty action is needed in order to achieve the same "quality" of temporary protection that can be accomplished by a single Safeguard Clause action. While this is not necessarily the case,[330] the difference in numbers between antidumping/countervailing measures and safeguard measures could be overstating the difference in usage.

6.1.3 Common denominators of existing suggestions for reform

The study of the four flexibility instruments in Chapter 5 included for each of them a description of existing suggestions for reform. I will now argue that for each instrument, the critical body of existing suggestions can be summarised by introducing a common denominator. Furthermore, it will be shown that the common denominators for all instruments are easily illustrated by using the framework established in Chart 6.3.

I begin with safeguard measures. In addition to the suggestions for a clarification of the rules in the Agreement on Safeguards, which are not aimed at a substantive change of the instrument, there have been proposals to reduce the compensation requirement. In contrast, no suggestions that are intended to lower the level of prerequisites have been made. The high level of prerequisites appears to be sacrosanct, and the recent increase in

[328] See the complaint ratios calculated in Chapter 3 and Stevenson (2003a). The latter argues that *most* recent safeguard measures are likely to be inconsistent with WTO rules.

[329] See *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121, 123, *Argentina – Definitive Safeguard Measure on Imports of Preserved Peaches*, WT/DS238, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products,* WT/DS98, *US – Definitive Safeguard Measures on Imports of Certain Steel Products*, WT/DS248, 249, 251, 252, 253, 254, 258, and 259, *US – Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea*, WT/DS202, *US – Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat from New Zealand and Australia*, WT/DS177, 178, and *US – Definitive Safeguard Measure on Imports of Wheat Gluten from the European Communities,* WT/DS166.

the application of safeguard measures is probably regarded as a useful justification for this mindset. Chart 6.4 summarises the direction of substantive suggestions.

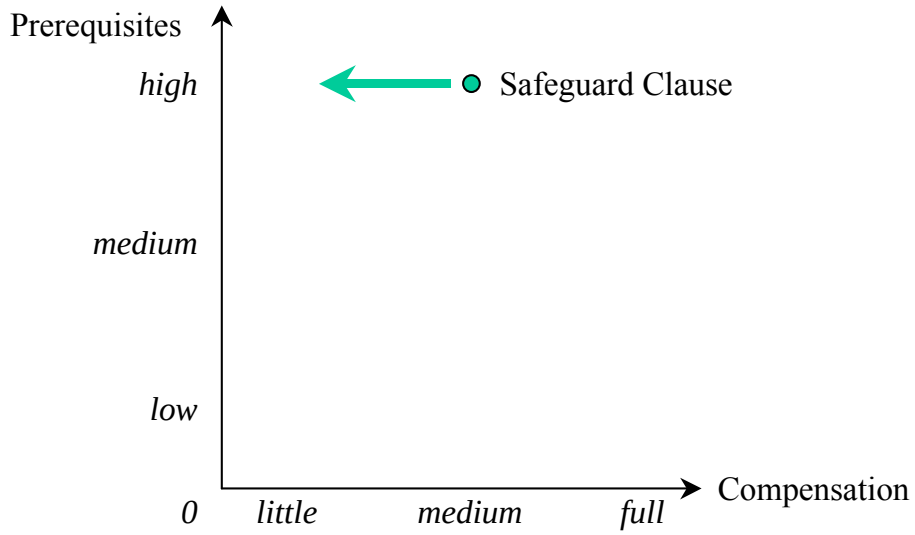

Chart 6.4: Safeguard Clause: common denominator of existing suggestions

The existing suggestions for reform of the antidumping regime mainly involve raising the level of prerequisites by focusing on the calculation of the dumping margin, the inclusion of market structure analysis in the investigation, and the determination of injury. On the other hand, there are no proposals to combine the instrument with the provision of compensation for the trading partners affected, due to the unfair trading argument that is inherent in antidumping action. The main direction for reform is accordingly represented by the arrow in Chart 6.5.

[330] Remember that there are possibilities of introducing selectivity in a Safeguard Clause action. Furthermore, if there is one dominant exporter, it is of marginal importance whether the import-restricting measure is non-selective or discriminatory against him.

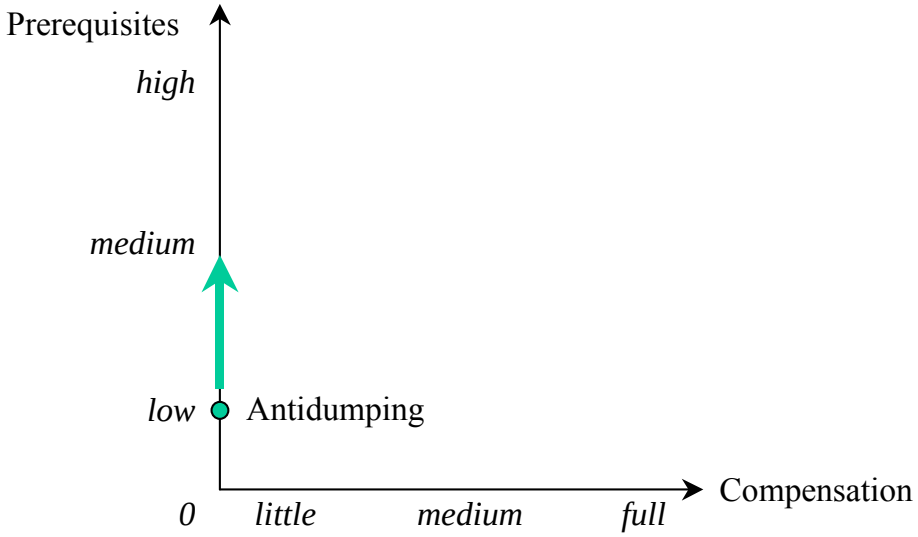

Chart 6.5: Antidumping: common denominator of existing suggestions

The course for countervailing duties is similar. The proposals range from increased requirements with respect to benefits conferred to the subjection of countervailing duties to the stricter regime of the Safeguard Clause. All these proposals are intended to raise the level of prerequisites while abstaining from requiring compensation. Again, the reason for the neglect of compensation is obvious: subsidies could not be demonised as an unfair practice any more if countervailing action were made dependent on the provision of compensation. Chart 6.6 summarises these considerations.

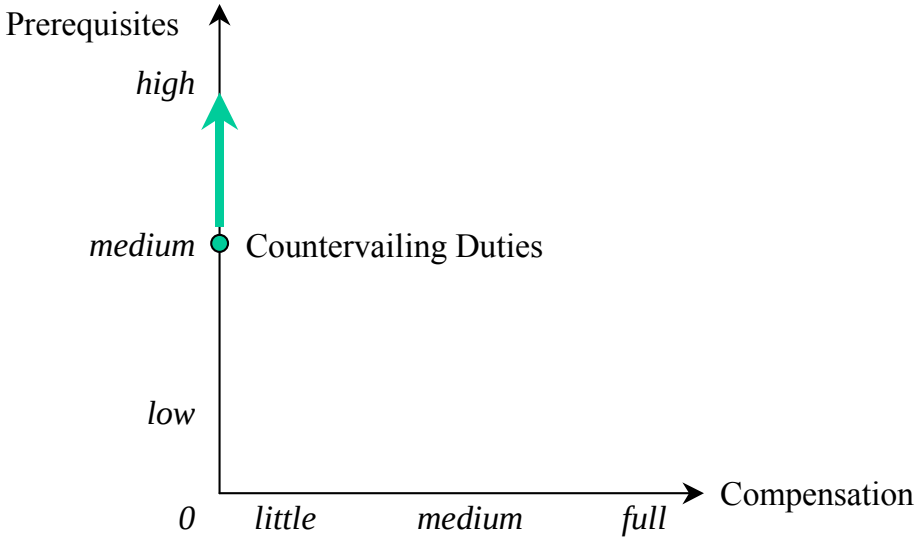

Chart 6.6: Countervailing duties: common denominator of existing suggestions

The last instrument to be discussed is the violation of WTO agreements. As shown in the preceding chapter, many procedural aspects of the current dispute settlement regime have been singled out for potential reform. However, the proposals intended to strengthen the enforcement of WTO law by aggravating the consequences of non-compliance are of the most substantive nature. Yet there have been only few suggestions focusing on a higher level of retaliation: no one seems to be satisfied that WTO-inconsistent import restrictions are countered by trade-inhibiting policies. Actual retaliatory actions have had ambiguous effects. In the *Hormones* case, for example, the EC does not seem willing to change its behaviour despite the suspension of concessions by the US and Canada.[331] Furthermore, complainants who are authorised to retaliate often shy at doing so. This is most obvious in the *FSC* case.[332]

It is this general dissatisfaction with retaliation that has brought compensation to the forefront of discussion. The respective suggestions are inspired by the trade-promoting nature of compensatory market access. The world trading system is still far from a unanimous perception that violations ought to be accompanied by compensation, but there is a growing number of voices that would like to alter the non-binding language of Article 22:1 DSU ("Compensation is voluntary [...]"). This tendency is displayed in Chart 6.7.

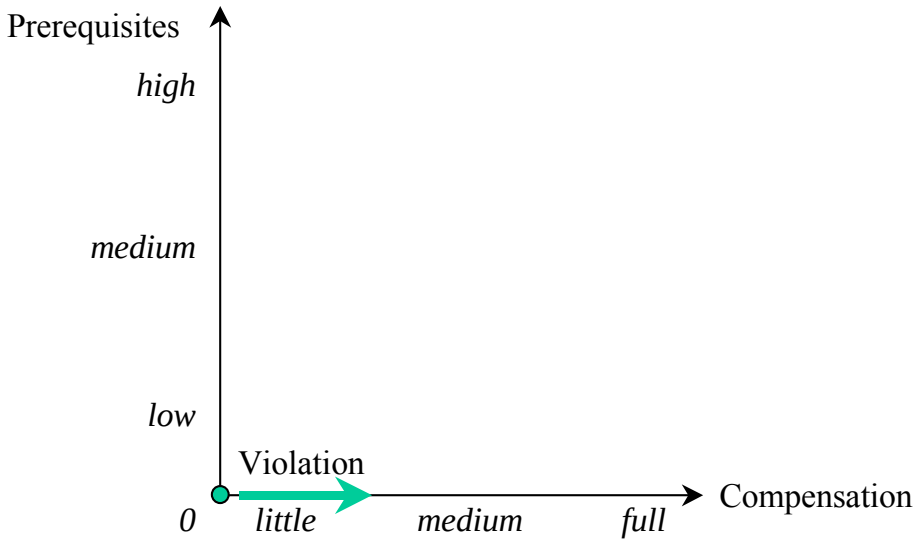

Chart 6.7: Violations: common denominator of existing suggestions

[331] *EC – Measures Affecting Meat and Meat Products (Hormones)*, WT/DS26. The EC adopted the Directive 2003/74/EC of 22 September 2003, amending Council Directive 96/22/EC, and considers that it has now fully implemented the recommendations of the DSB in the aforementioned dispute. See the website of the European Commission.

[332] *US – Tax Treatment for "Foreign Sales Corporations"*, WT/DS108.

Chart 6.8 summarises Charts 6.4 to 6.7. Obviously, existing suggestions for the reform of flexibility indicate that the "optimal" lawful instrument for temporary protection is found in the upper-left region of the plane. This region is qualified by a high level of prerequisites, while compensation is not owed. As regards the violation instrument, the prerequisites path is barred, which is consistent with intuition. Instead, existing suggestions envisage a more prominent role for compensation. I am tempted to conclude that the compensation concept is regarded as some kind of last resort, useful only to the extent that a rise of prerequisites is technically not feasible.

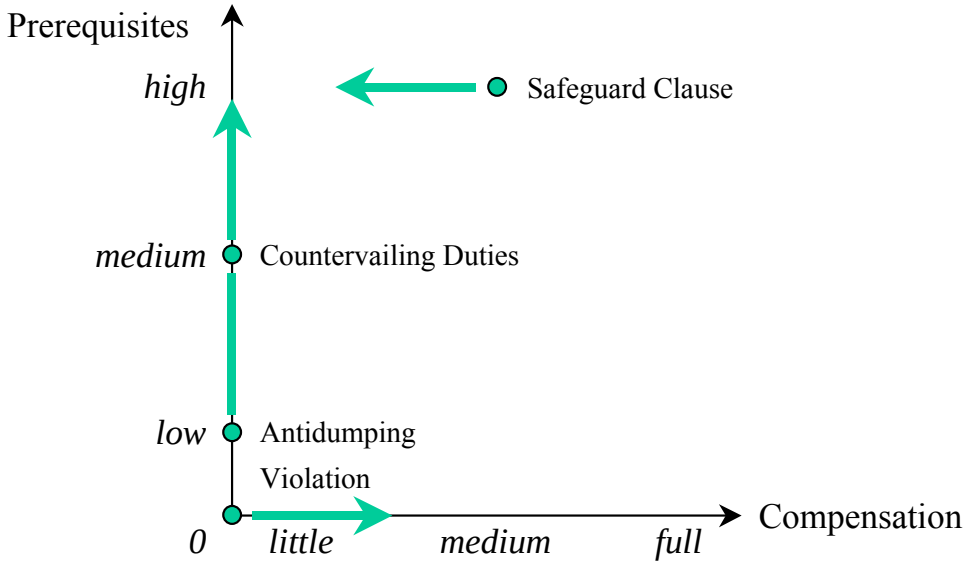

Chart 6.8: Existing suggestions for reform of flexibility instruments

Higher prerequisites for temporary import restrictions impair the government's trade policy flexibility. In the following section, I will argue that the attempt to raise the level of prerequisites for lawful flexibility instruments runs the risk of provoking one of two negative consequences, or possibly a combination of both: (1) governments are not willing to conclude respective multilateral negotiations any more. This means that today's regime would remain unchanged;[333] (2) governments finally agree to raise the overall level of prerequisites for lawful temporary protection, but this causes an increase in

[333] According to the "bicycle theory", a standstill in the liberalisation process can even impair the level of liberalisation that has already been achieved: if the expectations of future liberalisation were disappointed by a standstill, the value of future benefits from the international trade agreement would be reduced. However, this value is crucial for the readiness of governments to co-operate. Remember equation (4.36) in Chapter 4. The bicycle theory is further explored in Staiger (1995), Bhagwati (1988), and Bergsten (1975).

violations – or, at the extreme, a withdrawal of membership from the WTO (and a re-orientation to regional integration strategies).

My argument is based on a simple theoretical framework that I develop below and on historical experience with the reform of flexibility instruments. Note that the focus on rising prerequisites does not *necessarily* lead to one of the negative consequences. However, such a development is plausible – and can definitely not be excluded. Therefore, it is warranted to consider *alternative* means of reducing the number of temporary import restrictions, which go beyond raising the level of prerequisites.

6.2 Developing a new institutional design of flexibility

6.2.1 A simple theoretical framework for the study of trade policy flexibility

A small economy is considered, facing exogenously-given world prices. The government is in charge of trade policy and maximises its own objective function. In the tradition of the political-support approach, the goal of re-election is in the back of its mind, but the electoral campaign is not explicitly modelled. After an international trade agreement has been concluded, the objective function consists of two components: (1) social welfare and (2) the support from strong import-competing sectors, where their strength is measured in terms of political influence. It bears close resemblance to the objective function used by Grossman and Helpman (1994). Remember from Chapter 4 that their government utility function is

$$(6.1)\quad G = \beta W + (1-\beta)\sum_{i=1}^{n} C_i$$

with W representing social welfare, C_i being the contribution schedule of sector i, and $\beta \in [0,1]$ illustrating the weight that the government attaches to social welfare, relative to political contributions. While the first component of my theoretical framework corresponds to the first component in equation (6.1), the second component in equation (6.1) is broader in including not only import-competing, but also export interests. However, this difference is not of a fundamental nature: since export interests generally

do not conflict with social welfare considerations,[334] they could be subsumed under the first component of my objective function.

My theoretical framework further distinguishes between two political circumstances (or: states of the environment) that can occur after an international trade agreement has been concluded: (1) normal political circumstances and (2) exceptional political circumstances. They can be thought of as two different weighting factors used in order to determine the relative importance of the components in the government objective function. In terms of the Grossman-Helpman model, one would have β^{normal} and $\beta^{exceptional}$ with

$$\beta^{normal} > \beta^{exceptional}.$$

Under normal political circumstances, the government favours social welfare. It abstains from introducing temporary import restrictions, *provided that* it cannot change the balance of market access concessions codified in the international trade agreement. This market access balance was defined in Chapter 4 as the foreign market access for domestic exporters relative to the domestic market access for imports. Why do I make this qualification of government benevolence? While an improvement of the market access balance by means of import restrictions is welfare-reducing, it is appealing under a mercantilistic perspective. As a matter of fact, mercantilism still has a strong influence on the mindset of politicians.[335]

In contrast, under exceptional political circumstances, defined as political stress, the fortune of the government entirely depends on the support from a particular import-competing sector. This dependence results in

$$\beta^{exceptional} = 0.$$

Under such circumstances, temporary import restrictions in the respective sector are unavoidable, and no consideration is given to social welfare. Normal and exceptional political circumstances alternate over time. Drawing on empirical results with respect to

[334] Both tend to favour free trade. The possibility of export subsidies is excluded, which is not unusual in the literature on the political economy of trade policy, see Ethier (2003).

[335] Mercantilism does not explicitly enter my government objective function, but can be subsumed under its second component, since I consider only import-restricting (and not export-promoting) measures.

the extent of government benevolence,[336] their high levels for β let me suggest that normal circumstances are the rule.

Distinguishing between normal and exceptional circumstances is quite common in the trade policy literature.[337] Exceptional political circumstances, or political stress, are provoked by an import-competing sector that for a while gains dominant influence on the government. I do not model the process leading to such a situation, but assume that it occurs regularly. This influence is strong enough to determine the fortune of the government, which will therefore introduce temporary import restrictions in this sector. It is important to argue that the international trade agreement cannot be made contingent on political circumstances, because political stress cannot be contractually specified. In particular, it is impossible to predict which sector will be dominant and which *economic* circumstances will prevail at the time of *political* stress. The agreement is necessarily incomplete in this respect.[338] In order to be able to restrict imports under exceptional political circumstances, governments depend on trade policy flexibility.

A contingent protection mechanism such as today's Safeguard Clause is unable to provide a sufficient level of trade policy flexibility: its use is made dependent on the fulfilment of high prerequisites, and these are all based on economic criteria, such as serious injury caused by rising imports. Exceptional political circumstances, however, are not defined by economic variables, but by political stress. Although the two are often correlated, this is not always the case. The government might have to introduce temporary protection in an import-competing sector even in the absence of rising imports, because the sector has been able to increase its political influence to an extent where it dominates the political agenda.[339] On the other hand, the self-interested government might not see a political need to support a rapidly declining, but politically weak import-competing sector, although all prerequisites for contingent protection would be fulfilled.

Trade policy flexibility can only be sufficiently provided by an instrument that features low (or even no) prerequisites. Antidumping, as currently designed, fulfils this requirement. Countervailing measures do so to a lesser extent. However, from an overall

[336] See Goldberg and Maggi (1999) as referred to in Chapter 4.
[337] Exceptional circumstances are often called "shocks". See e.g. Downs and Rocke (1995).
[338] This is in accordance with the Ethier model discussed in Chapter 4.
[339] A complete absence of rising imports has been claimed, for instance, in the recent *Steel* case (US safeguard measures in March 2002), see Durling (2002).

perspective, trade policy flexibility is not impaired as long as there is at least *one* instrument featuring low prerequisites. This instrument can be used as a fallback option whenever the prerequisites of other instruments are not fulfilled. In this sense, individual instruments are exchangeable.[340]

In contrast, the existing suggestions for reform with their focus on raising the general level of prerequisites for lawful flexibility instruments are diametrically opposed to appreciating the need for trade policy flexibility. My theoretical framework implies that this focus runs the risk of provoking one of two undesirable scenarios. The first scenario is that governments will never approve such a reform, knowing that they would have to restrict imports at times of political stress even if the suggested level of prerequisites were not fulfilled.[341] A classical standstill of negotiations would be the consequence, as regularly experienced in the history of multilateral trade liberalisation. A synonym to this standstill would be minuscule changes in the existing design. These would soon be discovered as an ineffective body of new rules, although possibly celebrated as a breakthrough in the beginning.

The second scenario is that a new agreement brings about substantive change by raising the level of prerequisites for lawful flexibility instruments. The consequence, however, would be that violations remain the only useful instrument from a trade policy flexibility perspective: governments would be *urged* to depart from the rules in periods of political stress. The number of violations would increase.

Which of the two scenarios – an *ex-ante* standstill in negotiations or an *ex-post* increase in violations – is more probable? As explained below, this depends on a variety of factors, notably on

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[340] See Finger (1998) for a similar argument.

[341] Actually, it is often not acceptable to governments to give up trade policy flexibility even in a *regional* integration setting, although similarities among members would be higher there. For example, Canadian proposals for a replacement of US trade remedy law by a common competition policy failed during the negotiations of the NAFTA because the US considered the political costs to be too high. According to a senior official of the Canadian *Competition Bureau*, Christopher Martin, it is unlikely that Canada and the US will *ever* agree to replace existing trade remedy laws. In his opinion, examples of a successful elimination of trade remedy laws in regional integration agreements (e.g. the EC or the European Economic Area) have been the result of a transition to comprehensive schemes that include social and regulatory integration as well. See the *International Trade Reporter*, Vol. 19, No. 18, 2 May 2002. Cernat and Laird (2003) show that flexibility instruments (notably antidumping) are still used in a variety of advanced regional integration agreements.

(1) the strength of import-competing sectors at the time of negotiating the international trade agreement;

(2) the attitude of governments towards the violation of agreements;

(3) the planning horizon of governments.

The theoretical framework has outlined the role of a strong import-competing sector *after* an international trade agreement has been concluded. In periods of political stress, the government has to introduce temporary import restrictions because its fortune depends on the support from this sector. If there were no lawful instrument available, the government would not shy at violating the agreement. In this sense, my theoretical framework has focused on the second stage of a two-stage game, taken the existence of an international trade agreement as given. In order to evaluate the three factors mentioned above, however, the first stage of the game must be analysed: the negotiation phase.

Realistically, import-competing interests are present in this first stage already. They lobby for a trade agreement that includes at least one instrument featuring low prerequisites for temporary import restrictions. However, although my theoretical framework assumes that these sectors are able to enforce temporary protection in the second stage of the game, it is not clear whether they are able to signal their future strength in the negotiation phase. Some governments could perceive the probability of frequent political stress as small, because import-competing sectors are weak at the time of negotiating the agreement. If the number of governments with this perception was sufficiently high, they might conclude an agreement that envisages high prerequisites for temporary protection. Therefore, scenario two should be expected, which predicts an increase in violations in the second stage of the game.

The attitude of governments towards violations plays a significant role in the negotiation phase. In stage two, by contrast, the use of this instrument in periods of political stress will only depend on the availability of a lawful flexibility instrument. Governments would not accept an agreement that features high prerequisites for lawful flexibility instruments if they had a strong aversion against illegal behaviour. Scenario one would occur. However, such an aversion is not self-evident: a trade agreement can be concluded despite the fact that some members are not willing to accept all of its elements. Its conclusion is

then an expression of the desire to preserve an agreement on essential points. Contentious rules would find their way into the text, but would be incorporated in "hortatory or imprecise provisions"[342], or implicitly left for future renegotiation, triggered by a violation. In sum, scenario two becomes more probable when the attitude of governments towards violations is more permissive.

The third factor, the planning horizon of governments, is also important in stage one of the game. International trade agreements are regularly concluded for an indefinite time. The GATT is now more than fifty years old. However, governments often take a short-time perspective since their survival is not guaranteed after the next elections. A government that expects to resign soon after the conclusion of negotiations might be ready to make concessions that it would never offer if it expected to stay in office in the medium and long run. After the agreement has been concluded and the election is over, the new government could be forced to violate these concessions.

6.2.2 Past attempts to raise the prerequisites

The multilateral system has delivered an impressive performance in reducing permanent tariff rates since the formation of the GATT in 1947, as shown in Chart 2.2. For many products, tariff rates are zero or close to zero today. This is particularly true for industrial products exported to developed countries. Trade in agricultural products and exports to developing countries are still constrained by significant barriers, but there are a few signs of improvement.

The history of temporary protection is, however, a different one. In fact, there has been only one effective restriction of an important instrument for temporary protection: VERs were forbidden by Article 11 of the Agreement on Safeguards in 1995. However, even this "success story" should be interpreted with care: VERs can still be concluded in secret, and as long as no one complains, the public does not know about it. Lee (2002a), for instance, suspects that the US and Canada resorted to "grey-area measures" after 1995 in their Softwood Lumber Agreement.[343]

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[342] Abbott and Snidal (2000), p. 445.

[343] The *US-Canada Softwood Lumber Agreement* was signed in 1996 after more than 15 years of dispute concerning the "fairness" of US-Canadian trade in softwood lumber. The original agreement expired in March 2001. The latest development is the condemnation of US countervailing duties by a WTO panel,

Apart from the prohibition of VERs, however, there has not been any effective move to raise the prerequisites for temporary import restrictions. The prerequisites of the Safeguard Clause are high, yet they were already high in 1947. There have been no substantive changes regarding this criterion since then, and the core of prerequisites are still increased imports, serious injury, unforeseen developments, effect of obligations incurred under the GATT, and causal relationship. As regards antidumping and countervailing measures, there were manifest attempts during the Uruguay Round to conclude agreements that would bring about a higher level of prerequisites than experienced before. This is particularly true for antidumping: the use of this instrument had been strong in the years leading to the Uruguay Round, and it was felt that something must change. At the first glance, negotiators succeeded in their efforts, and observers were optimistic that there would be a reversal of the tendency to make the imposition of antidumping easier. However, as the numbers in Chapter 3 have shown, the use of the instrument was not restrained in the following years, but became more popular instead. According to the preceding subsection, the first scenario eventuated: regulatory changes have been small and ineffective, although initially celebrated as a breakthrough.

What can be expected from the current negotiations of the Doha Round? The declaration of intent passed at the Fourth Ministerial Conference in November 2001 has no reference to the Safeguard Clause. While this does not preclude the possibility that members engage in respective negotiations, the Clause is no priority topic at the moment. This is different for antidumping and countervailing duties. The Doha declaration explicitly mentions the two instruments:

> In the light of experience and of the increasing application of these instruments by Members, we agree to negotiations aimed at clarifying and improving disciplines under the Agreements on Implementation of Article VI of the GATT 1994 and on Subsidies and Countervailing Measures, while preserving the basic concepts, principles and effectiveness of these Agreements and their instruments and objectives [...].[344]

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see *US – Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada,* WT/DS257.

[344] Ministerial Declaration of the Forth Ministerial Conference, Doha, 9-14 November 2001, Document No. WT/MIN(01)/DEC/W/1, Para. 28.

The WTO members recognise the growing use of the two flexibility instruments[345] and identify a need for improved disciplines. However, does this indicate a rise in prerequisites? There is a group of countries, named the "Friends of Antidumping Negotiations", which seems to promote such a development.[346] The group includes some active antidumping users of the recent past, notably Brazil and South Korea.[347] On the other hand, however, the US takes a tough stance: it does not want to see its access to these instruments restricted.[348] Indeed, the US was successful in inserting its position into the Doha declaration: the document emphasises the preservation of "basic concepts, principles and effectiveness" in the current regime of antidumping and countervailing duties. As Broude (2003, p. 306) notes, the declaration has "not a word about reconsidering their very necessity or prudence." It thereby confirms that nothing should be expected with regard to a fundamentally changing appraisement of the two trade remedies, but that any modification will only be cosmetic. Finger and Zlate (2003, p. 14f), surveying a range of member proposals, argue that:

> The preponderance of the [Doha Round] proposals [...] reflect thinking within the box. Members who would like to see fewer antidumping measures propose to tweak the existing structure of rules in one direction, other Members prefer to hold the line. This struggle over technicalities, we contend, will have no impact on the quality of import restrictions that receive legal sanction under the antidumping agreement, little impact on the quantity.[349]

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[345] This recognition relates at least to antidumping. With regard to countervailing duties, it is not clear from the text if members recognise their growing use, or if they refer to the growing use of subsidies.

[346] For example, they request the amendment of Article 2:4:2 of the Agreement on Antidumping in order to explicitly provide that all positive *and* negative dumping margins must be added up (see the WTO-Document No. TN/RL/W/113, dated 6 June 2003). Furthermore, they seek more precise guidelines on several key concepts of the Agreement, such as injury, normal value, constructed export price etc. Less related to the prerequisites – but still important – is the request to make the "lesser duty rule" mandatory rather than optional as is currently the case in accordance with Article 9:1 (see Document No. TN/RL/W/119, dated 16 June 2003).

[347] The other members are Chile, Colombia, Costa Rica, Hong Kong, Israel, Japan, Norway, Switzerland, Taiwan, Thailand, and Turkey.

[348] The US aims at ensuring that the right to use trade remedies is not diminished. In contrast, it seeks to prevent the circumvention of antidumping measures. See the *Cancún Update* of the *Doha Round Briefing Series*, Vol. 2, No. 7, August 2003. Active support in this respect comes from Egypt, see its proposal in Document No. TN/RL/W/110, dated 22 May 2003. For a general description of the US stance towards the proposals of the "Friends" see the *International Trade Reporter*, Vol. 19, No. 42, 24 October 2002.

[349] Debra Steger, former head of the WTO's Appellate Body Secretariat, argues that antidumping is increasingly seen as a "property right". She does not think that the Doha Round will bring any reform of trade remedy laws. See the *International Trade Reporter*, Vol. 19, No. 18, 2 May 2002.

Thus far, there is no indication that the Doha Round will achieve any substantial reform and raise the level of prerequisites of antidumping and countervailing duties. While the failure of the Fifth Ministerial Conference in Cancún in September 2003 was not due to diverging interests over these instruments, there were no signals that suggest any noteworthy progress in this area.

6.2.3 A principle lack of readiness for reform? The prisoner's dilemma

The preceding two subsections argued that governments are not willing to give up trade policy flexibility by raising the prerequisites of lawful trade remedies. They would either fail to negotiate a respective agreement or violate it after its conclusion. Does this mean that there is no possibility of reforming the institutional design of flexibility? Are governments happy with today's situation and therefore inaccessible as regards calls for a reduction in the number of temporary import restrictions? Probably not. Firstly, there obviously are attempts to modify antidumping and countervailing duty rules. It is still not clear whether the stated intentions of important protagonists in the Doha Round are more than a lip service, but there is at least no prominent WTO member who considers antidumping or countervailing duties as a non-negotiable topic. Secondly, Chapter 3 demonstrated not only that the use of antidumping (as the most important lawful flexibility instrument) increased after the end of the Uruguay Round, but also that it is more and more applied against traditional users themselves: the reciprocity ratios are high and substantially increasing for a variety of powerful countries.

High reciprocity ratios in turn support the notion that antidumping has degenerated into what game theorists call a "prisoner's dilemma". Countervailing duties risk being caught in a similar trap, although their use has been moderate thus far. In a prisoner's dilemma, the government uses a flexibility instrument under normal political circumstances in order to improve its market access balance, but since foreign governments do the same, market access balances eventually remain unchanged. Simultaneously, the overall level of market access deteriorates worldwide. This impairs social welfare and the objective function of the government. Such a dilemma can effectively stimulate reform. I argue, however, that the potential readiness of governments to restrict the use of antidumping and countervailing duties does not imply a willingness to sacrifice trade policy flexibility. While governments might finally agree that antidumping and countervailing duties are not in their common interest under normal political circumstances, they will reject a reform

that makes temporary protection impossible in times of political stress. Therefore, an alternative strategy to the rise of prerequisites must be found.

6.2.4 An alternative to the rise of prerequisites

My theoretical framework predicts that governments use antidumping and countervailing duties even under normal political circumstances, because they are able to improve the balance of market access concessions. However, the analysis of reciprocity ratios reveals that governments should eventually discover the prisoner's dilemma character of these trade remedies. This in turn could promote reform. In other words, the missing readiness to sacrifice trade policy flexibility does not imply that governments will not consider other ways of reducing the number of temporary import restrictions under normal political circumstances.

An alternative to the rise of prerequisites would consist of shifting the focus from prerequisites to compensation. A new regime might maintain the trade policy flexibility inherent in current antidumping and countervailing duty rules by defining low or even no prerequisites for temporary protection. However, any import restriction would require full trade compensation for trading partners that have been negatively affected. Note that the full-compensation requirement corresponds to the commensurate price for trade policy flexibility in the Ethier model of Chapter 4, restoring the reciprocity of market access concessions. Furthermore, full compensation ensures that no government introduces temporary protection under normal political circumstances, because the market access balance would remain unchanged. On the other hand, governments would be able to satisfy the interests of strong import-competing sectors at times of political stress. Trade policy flexibility is not impaired.

In contrast to high prerequisites, based on economic criteria, the compensation concept does not interfere with the political nature of exceptional circumstances. Full compensation makes it needless for governments to specify circumstances in which temporary protection may be introduced: it automatically induces governments to raise import barriers only under exceptional political circumstances, and never under normal ones. Therefore, my alternative solution should lead to a reduced number of temporary import restrictions as compared to the situation today.

6.2.5 Implementing the alternative solution

The implementation of the alternative solution could pursue two different directions, and I will discuss them in turn. The first direction is characterised by maintaining antidumping and countervailing duties as they are today, but combining them with full compensation. Although conceptually interesting, it can be shown that this combination is not promising. In contrast, the second direction merits considerable attention. It envisages the abolition of antidumping and countervailing duties, supplemented by two modifications of the Safeguard Clause: (1) removal of all prerequisites and (2) introduction of mandatory trade compensation without exception.

6.2.5.1 Antidumping and countervailing duties with compensation?

It has been argued that it would be difficult to raise the prerequisites of antidumping and countervailing duties. Therefore, an alternative strategy could be to leave the level of prerequisites untouched and focus instead on the introduction of compensation. Chart 6.9 visualises this strategy.

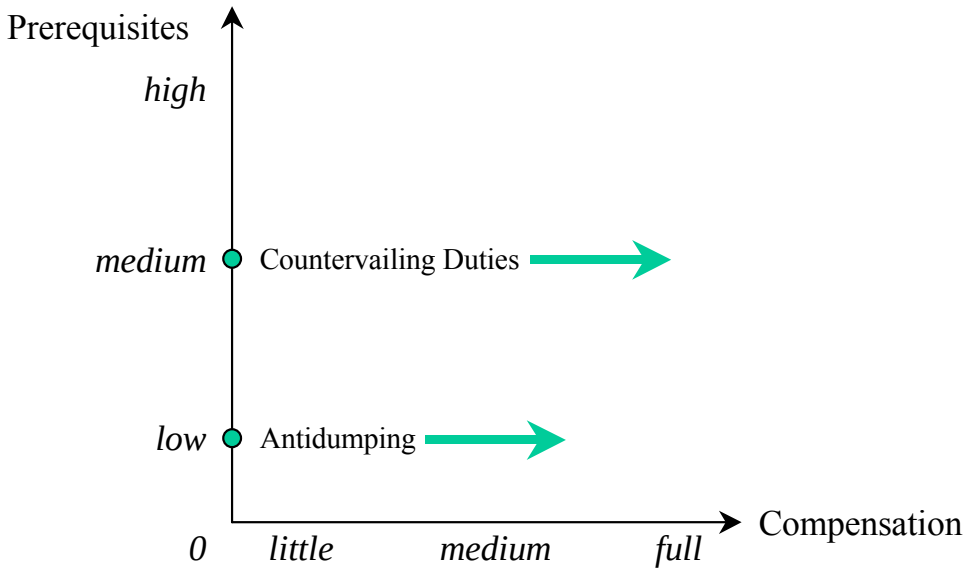

Chart 6.9: The first direction for implementing the alternative solution

Remember from Chapter 5 that existing suggestions for reform were *not* intended to make antidumping and/or countervailing duties contingent on the provision of compensation. This is hardly astonishing, since the alleged connection between the two instruments on the one hand and unfair trade on the other hand is obviously not reconcilable with

providing compensation for (unfair!) foreign exporters. Before proposing compensation, it would be necessary to get rid of the unfair trading argument. However, this would deprive both instruments of their official justification.

That being said, it should be recognised that measures against alleged dumping or subsidisation were actually accompanied by compensatory effects on several occasions in the past. This was the case whenever antidumping or countervailing duty investigations were terminated by a voluntary price undertaking.[350] Such an undertaking helps to restrict imports of the product in question, but shifts rents to the foreign exporter by raising export prices. It is a form of managed trade admissible under both the Agreement on Antidumping and the Agreement on Countervailing Measures.[351] However, these compensatory effects are an outgrowth of abandoned investigations, not a feature of antidumping and countervailing duties themselves. Whenever investigations lead to definitive measures, there is no compensatory effect any more. In addition, this form of managed trade runs counter to the aim of banning VERs, stipulated by the Agreement on Safeguards. In sum, it does not look promising to combine the two instruments with full compensation. The implementation of the alternative solution must obviously be based on a more fundamental change of the current system.

6.2.5.2 The basics of a revised Safeguard Clause

The idea of restraining antidumping action by a more attractive Safeguard Clause is not new.[352] Similar considerations can be made as regards a restraint of countervailing duties. However, I am not aware of any proposal that considers a reduction – let alone an elimination – of prerequisites for the purpose of raising the attractiveness of the Safeguard Clause. The prerequisites of the Clause appear to be sacrosanct. This is problematic for three reasons. Firstly, prerequisites based on economic criteria are a questionable component of temporary protection because they do not respect the inherently political nature of exceptional circumstances. Secondly, thinking about concepts such as injury, causal effect, unforeseen developments, and the like, lobbying in the presence of

[350] See Ethier (1998) and Prusa (1992).

[351] See Article 8 of the Agreement on Antidumping and Article 18 of the Agreement on Countervailing Measures. Bown (2002) mentions a second method of rent-shifting that has been practised in the context of antidumping: in many cases of formal trade disputes concerning antidumping measures, the defendant evaded a DSB ruling (and its potential consequences) by withdrawing the measure and *refunding* the duties which had been collected.

prerequisites mostly involves convincing the government that the current situation fits exactly into the straightjacket mandated by these prerequisites. Taking into account the information asymmetries to the disadvantage of governments, it is conceivable that protection-seeking interests sometimes have an easy case. In other words, the verification of prerequisites is not regularly based on an independent assessment.[353] Thirdly, the actual selection of prerequisites in today's Safeguard Clause reflects considerable arbitrariness and can hardly be based on sound economic reasoning.[354] As argued in Chapter 5, it is doubtful that the structural adjustment argument for the Clause has any merits on economic grounds. Furthermore, structural adjustment is not even prescribed by Article XIX GATT or the Agreement on Safeguards.

An elimination of the prerequisites in the Safeguard Clause would enable governments to give up the antidumping and countervailing duty instruments without compromising trade policy flexibility. There would not be a need to resort to the violation instrument under exceptional political circumstances: governments could decide when to introduce *lawful* temporary protection. At the same time, however, the form of protection would have to satisfy the MFN principle of Article I GATT and the prohibition of (1) quantitative restrictions in accordance with Article XI and (2) other non-tariff barriers. Furthermore, the revised Safeguard Clause would have to entail mandatory trade compensation on an MFN basis. Therefore, today's exception to the compensation requirement in the case of absolutely rising imports would cease to exist. Chart 6.10 represents this solution graphically.

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[352] See e.g. Bown (2002).

[353] Robertson (1992), referring to the injury prerequisite of the Safeguard Clause, confirms that "[...] the determination of serious injury is often based on domestic political pressures, not on economic analysis" (p. 43).

[354] It might therefore not be a surprise that some of these prerequisites do not appear in the context of safeguard provisions outside the GATT context. For example, the Agreement on Agriculture has "Special Safeguard Provisions" in its Article 5. There, a temporary import restriction is authorised when the import volume exceeds a trigger level *or* when the price at which imports enter the customs territory falls below a trigger price. There are no prerequisites based on injury, causal relationship, unforeseen development or effect of liberalisation.

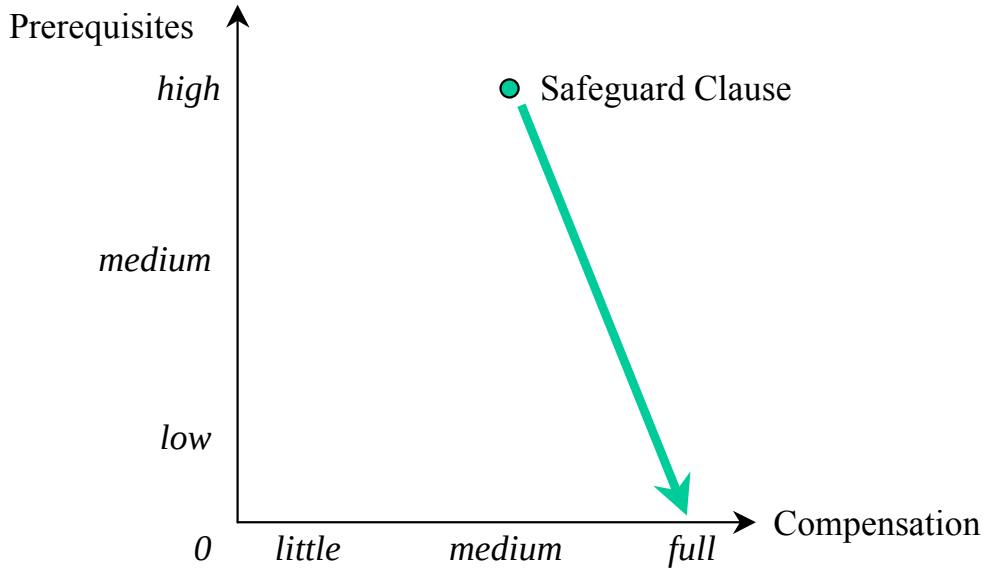

Chart 6.10: The second direction for implementing the alternative solution

The principles of this revised Safeguard Clause are resembling to those found in the renegotiation provisions of Article XXVIII GATT. Paragraph 5 of this article enables a contracting party to introduce non-discriminatory import restrictions at any time by modifying its schedule of concessions, provided that it reserves this right by regular notification at three-year intervals. Import restrictions based on Article XXVIII have to be accompanied by full trade compensation ("compensatory adjustment") for negatively-affected parties,[355] otherwise these parties have a right to retaliate. Despite its relatedness, however, Article XXVIII is by no means a substitute for the revised Safeguard Clause. The former is the basis for a permanent modification of concession schedules, which is difficult to revoke and requires negotiations[356] with affected parties before it can be implemented. Therefore, it is not a flexibility instrument. The revised Safeguard Clause offers temporary protection that is rapidly available and can be terminated promptly, without the burden of modifying the schedules of concessions.

[355] Para. 2 reads: "[...] the contracting parties concerned shall endeavour to maintain a general level of reciprocal and mutually advantageous concessions not less favourable to trade than that provided for in this Agreement prior to such negotiations."

[356] Although Para. 5 envisages a final *unilateral* withdrawal of a concession without the consent of affected trading partners, a negotiation process cannot be escaped. Before unilateral action is taken, Para. 1 requires "[...] negotiation and agreement with any contracting party with which such concession was initially negotiated and with any other contracting party [with] a principal supplying interest [...], and [it is] subject to consultation with any other contracting party [with] a substantial interest in such concession." Only if no agreement were achieved, would a unilateral action be justified.

6.2.5.3 The design of compensation

The revised Safeguard Clause can only live up to its purpose if the provision of compensation occurs instantaneously and smoothly after a temporary import restriction has been introduced. Therefore, it seems worthwhile to consider pre-selecting a set of market access concessions that could be offered to negatively-affected parties. The latter would be able to choose among these concessions as soon as a temporary import restriction is introduced, but the concessions would become effective on an MFN basis. This resembles the proposals of Lawrence (2003) and Lindsey, Griswold, Groombridge and Lukas (1999) discussed in Subsection 5.4.3. They present their compensation concepts as an alternative – or as a complement – to retaliation in the case of non-compliance with DSB rulings. While this is a separate problem, their considerations about the optimal design of compensation are equally useful when compensation becomes an inherent element of a revised Safeguard Clause.

A standing arbitrator could accelerate the process of determining the proper value of full compensation. His decisions would be binding. Arbitration has thus far not been an element of the Safeguard Clause, but it plays a prominent role in the context of other deviations from initial concessions.[357] In order to make compensation more useful, a requirement would be that the respective market access concessions are of a permanent nature. This has the additional advantage that compensation can also be provided in non-tariff areas (such as domestic regulations), where any liberalisation is difficult to revoke. In the case of permanent compensatory concessions, their amount would be lower than the amount of concessions suspended by the import restriction, since the latter is not of a permanent nature. Technically speaking, the *present values* of (1) permanent compensation and (2) temporarily suspended concessions would have to be equivalent in

[357] Note in particular its role in the dispute settlement process, where Article 25:1 DSU recognises that "[e]xpeditious arbitration within the WTO as an alternative means of dispute settlement can facilitate the solution of certain disputes that concern issues that are clearly defined by both parties." Furthermore, Article 22:7 requests that "[t]he parties shall accept the arbitrator's decision as final and the parties concerned shall not seek a second arbitration." In the General Agreement on Trade in Services (GATS), an arbitrator can be included in the process of (permanently) modifying initial concessions in accordance with Article XXI. The potential power of arbitration is stated in Para. 4(a): "The modifying Member may not modify or withdraw its commitment until it has made compensatory adjustments in conformity with the findings of the arbitration." Otherwise, instant retaliation is authorised.

order to preserve the principle of a commensurate price for trade policy flexibility, deduced from the Ethier model in Chapter 4.

If, however, the import restriction persisted longer than initially expected, the amount of compensatory concessions would further increase. This progressive increase, up to the amount of concessions suspended by the initial import restriction, ensures that the government has an incentive to withdraw the import restriction as soon as the period of political stress is over. Furthermore, the progressive increase makes it possible to dispense with an explicit limitation of duration in the revised Safeguard Clause. In the hypothetical case in which the "temporary" import restriction is never revoked, the compensation concept ensures that the overall level and balance of market access is not less favourable than prior to the introduction of the protectionist measure.

A prominent critique of the compensation concept is that trade barriers are already low in many sectors, due to consecutive rounds of multilateral liberalisation. A further reduction would have little compensatory effect.[358] However, this critique is only partly justified. In fact, there is still ample scope for liberalisation, despite impressive multilateral tariff reductions since 1947. This is primarily true for developing countries, but to a considerable extent also for the developed world: market barriers are still high in sectors such as services, textiles, and agriculture.

Regarding the agricultural sector, for instance, the complexity of import barriers (consisting of tariff and non-tariff barriers, but also of domestic subsidy mechanisms) makes it difficult to assess the true level of current protection. A study by Oxfam (2003) highlights that even tariff barriers *alone* are considerable: average rates applied on agricultural products in the EC are 22 percent. In the US, the average rate is 14 percent. In the EC and Japan, over 40 percent of agricultural tariff lines covered under the Uruguay Round Agreement on Agriculture fall into the tariff-peak category, in which average rates are 28 and 50 percent, respectively. These averages conceal far higher levels of protection in some subsectors. Maximum tariffs on fruit and nuts in the US exceed 200 percent, and on meat in the EC 300 percent. In addition, tariff escalation is especially pronounced in agriculture. In the EC, fully processed food products are confronted by tariffs that are almost twice as high than tariffs on products in the first stage of processing. In the US,

[358] See e.g. Pauwelyn (2000).

importers of processed tomato sauces face tariffs that are five times higher than those levied on fresh tomatoes. In sum, there is considerable room for manoeuvre with regard to trade compensation by tariff reduction, not to mention possible reductions in non-tariff barriers.

Furthermore, compensation may be rare today, but it obviously does exist – not so much in response to the introduction of safeguard measures,[359] but as a feature in WTO disputes. Although there is little *direct* evidence that defendants offer compensation after having violated WTO agreements, the following statement, taken from a communication by Australia in the context of the Doha Round negotiations on improvements and clarifications of the DSU,[360] reveals that compensation actually is an issue:

> The DSU provides that compensation arrangements are temporary measures in the event that implementation is not achieved within a reasonable period of time (Articles 3:7, 22:1, and 22.8).
>
> It also provides that these compensation arrangements must be consistent with the covered agreements (Article 22:1). This includes MFN provisions.
>
> *We are concerned by a recent trend toward bilateral compensation deals agreed between parties* which have no timetable for implementation and which are not offered to other Members whose rights and obligations have also been nullified and impaired.

The addressed instances of compensation have presumably not been in compliance with the DSU. However, this is not relevant here. The only matter of interest is that there have been respective market openings. This contradicts once more the perception that there is no room for compensatory liberalisation any more.

Why do I argue for trade compensation, and not for monetary transfers? As shown in the preceding chapter, there have been suggestions to introduce financial transfers as a counterpart to the violation of WTO agreements. Why not use them as a counterpart to

[359] This is in contrast to the fifties, sixties, and seventies, where compensation played an important role, see Chapter 3. However, compensation is still an issue in some current safeguard cases. For example, as briefly mentioned in Chapter 3, the EC and the US discussed compensation under Article 8:1 of the Agreement on Safeguards in order to counter the negative impact arising from the US steel tariffs imposed in March 2002. *See the International Trade Reporter*, Vol. 19, No. 12, 21 March 2002.

temporary protection under the revised Safeguard Clause? The answer is simple: a Safeguard Clause that requires monetary compensation does not fulfil the no-financial-transfer requirement formulated in Chapter 2. In other words, such a Safeguard Clause would not be a flexibility instrument any more. If the introduction of temporary protection is contingent on a monetary transfer to negatively-affected parties, why not offer this transfer to the protection-seeking import-competing sector, instead of raising import barriers? This solution would be superior from an economic efficiency perspective. However, political restraints, as discussed in Chapters 2 and 4, do not allow such a strategy. This claim is supported by the fact that compensatory monetary transfers do not play a noteworthy role in any area of international relations.[361]

If governments were ready to give up antidumping and countervailing duties in exchange for a revised Safeguard Clause, they would not be inhibited from combating imports that are based on true predatory intent: national antitrust legislation should in general suffice as an instrument against anticompetitive behaviour.[362] Compensation would *not* be required. In the case of an exporter under suspicion of dumping not disposing of a protected home market, it is difficult to imagine that predatory intent exists.[363] Therefore, the antitrust procedure could be supplemented by an investigation into the contestability of the exporter's home market. Such an investigation might be guided by a multilateral

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[360] See Document No. TN/DS/W/8, dated 8 July 2002, p. 3. Emphasis added.

[361] In the trade area, the US-Singapore Free Trade Agreement (signed on 6 May 2003) and the US-Chile Free Trade Agreement (6 June 2003) are exceptions. The former states in Article 20:6:5 for the case of non-compliance: "The complaining Party may not suspend benefits if, within 30 days after it provides written notice of intent to suspend benefits or, if the panel is reconvened [for arbitration purposes], within 20 days after the panel provides its determination, the Party complained against provides written notice [...] that it will pay an annual monetary assessment. The Parties shall consult, beginning no later than ten days after the Party complained against provides notice, with a view to reaching agreement on the amount of the assessment. If the Parties are unable to reach an agreement within 30 days after consultations begin, the amount of the assessment shall be set at a level [...] equal to 50 percent of the level of the benefits the panel has determined [under arbitration] to be of equivalent effect or, if the panel has not determined the level, 50 percent of the level that the complaining Party has proposed to suspend [...]." The US-Chile agreement is similar. However, there has not been an actual monetary transfer up to now.

[362] While many authors discuss the substitution of antidumping by antitrust regulation (see e.g. Tavares de Araujo 2002, Boscheck 2001, Tharakan, Vermulst, and Tharakan 1998, Niels and ten Kate 1997, Hoekman and Mavroidis 1996, 1994, Morgan 1996, or Messerlin 1994), there is not much literature focusing on the relationship between countervailing duties and antitrust. However, the principles are the same. Horlick and Palmer (2002) discuss the substitution of countervailing duties by antitrust rules in the context of the Free Trade Area of the Americas.

[363] A protected home market would allow the exporter to cross-subsidise lower prices in export markets. Furthermore, parallel imports into the domestic market could be warded off.

competition agreement, providing for a harmonisation of national competition rules.[364] Less ambitious (and more realistic) would be the application of "positive comity": the competition authorities in the exporter's home country would treat favourably the request from abroad to conduct an investigation into the exporter's domestic base.[365]

6.2.5.4 The text of a revised Safeguard Clause

The following paragraphs show a possible reformulation of Article XIX GATT, incorporating the revisions suggested above. For comparative purposes, the text of today's Article XIX can be found in Appendix 8.4.

Article XIX(rev) GATT

Temporary Restrictions on Imports of Particular Products

1. *A contracting party shall be free to temporarily withdraw or modify concessions in respect of any product by use of a tariff measure. Such a safeguard action shall be applied to a product being imported irrespective of its source.*

2. *Before a contracting party shall take action pursuant to the provisions of Paragraph 1 of this Article, it shall give notice in writing to the Committee on Safeguards as far in advance as may be practicable and shall provide adequate opportunity for prior consultations with those contracting parties having a substantial interest as exporters of the product concerned.*

3. *In critical circumstances where delay would cause damage which would be difficult to repair, a contracting party may take a provisional safeguard measure. The duration of the provisional measure shall not exceed 60 days, during which period the pertinent requirements of Paragraph 2 of this Article shall be met.*

4. *A contracting party applying a safeguard measure shall endeavour to maintain a substantially equivalent level of concessions to that existing under GATT 1994*

[364] See Meiklejohn (1999) for a discussion of this suggestion. Hauser and Schöne (1994) doubt the need for harmonised competition rules since predatory intent can be sufficiently countered by national antitrust rules according to the "effects doctrine". However, they recognise that a multilateral competition agreement could be a precondition in order to get the *political support* for restraining the antidumping instrument.

[365] See Tharakan, Vermulst and Tharakan (1998) and Hoekman and Mavroidis (1996).

between itself and the exporting parties which are affected by such a measure. To achieve this objective, the contracting party shall provide adequate means of trade compensation for the adverse effects of the measure on their trade.

5. *(a) A standing arbitrator is hereby established. Resort to arbitration can be requested by any contracting party if no agreement on trade compensation is reached between the contracting party applying a safeguard measure and the exporting parties which are affected by such a measure.*

   (b) The parties shall accept the arbitrator's decision as final.

6. *(a) Safeguard measures shall not be applied against a product originating in a developing country contracting party as long as its share of imports of the product concerned in the importing contracting party does not exceed 3 percent, provided that developing country contracting parties with less than 3 percent import share collectively account for not more than 9 percent of total imports of the product concerned.*

   (b) Safeguard measures shall not be applied against a product originating in a Least Developed Country.

7. *The Committee on Safeguards, under the authority of the Council for Trade in Goods, which shall be open to the participation of any contracting party indicating its wish to serve on it, has the following functions:*

   (a) to monitor and report annually to the Council for Trade in Goods on the general implementation of this Article and make recommendations towards its improvement;

   (b) to find, upon request of an affected contracting party, whether or not the procedural requirements of this Article have been complied with in connection with a safeguard measure, and report its findings to the Council for Trade in Goods;

   (c) to assist contracting parties, if they so request, in their consultations under the provisions of Paragraph 2 of this Article;

   (d) to receive and review all notifications provided for in Paragraph 2 of this Article and to report as appropriate to the Council for Trade in Goods; and

(e) to perform any other function connected with this Article that the Council for Trade in Goods may determine.

8. To assist the Committee on Safeguards in carrying out its surveillance function, the Secretariat shall prepare annually a factual report on the operation of this Article based on notifications and other reliable information available.

9. A contracting party shall not seek, take or maintain any voluntary export restraints, orderly marketing arrangements or any other similar measures on the export or the import side. These include actions taken by a single contracting party as well as actions under agreements, arrangements and understandings entered into by two or more contracting parties.

10. Contracting parties shall terminate all safeguard measures taken pursuant to Article XIX of GATT 1994 that are inconsistent with this Article not later than eight years after the date on which they were first applied or five years after the date of entry into force of this Article, whichever comes later.

This modified Article XIX (which will henceforth be called Article XIX(rev)) would replace the existing Article XIX GATT. Furthermore, it would replace the entire Agreement on Safeguards. The following table lists the articles of today's Agreement on Safeguards. A short description is provided for all of them. Furthermore, the table annotates whether their contents have been adopted by Article XIX(rev), and – if not – provides a short reasoning.

Art.	Content	Adopted	Reasoning
1	General Provision	**no**	Introduces the Agreement on Safeguards. No substantive content.
2.1	Preconditions	**no**	The revised Safeguard Clause has no preconditions.
2.2	Non-discrimination	yes	(see Para. 1)
3	Investigation	**no**	No investigation is required since there are no prerequisites.
4	Serious Injury	**no**	The revised Safeguard Clause has no prerequisites.
5	Quota	**no**	The revised Safeguard Clause does not allow non-tariff measures (see Para. 1).
6	Provisional Measure	yes	(see Para. 3)
7	Duration and Review	**no**	The revised Safeguard Clause has no explicit duration requirement. No review can be required since there are no prerequisites.
8.1	Compensation	yes	(see Para. 4)
8.2	Suspension of Concessions	**no**	Since compensation is mandatory, a suspension of concessions is only authorised in accordance with the DSU.
8.3	Absolute Increase	**no**	The revised Safeguard Clause has no exception to the requirement of full compensation
9	Developing Countries	yes	(see Para. 6)
10	Pre-existing Measures	yes	(see Para. 10)
11	Prohibition of VERs	yes	(see Para. 9)
12	Notification and Consultation	yes	(see Para. 2)
13	Surveillance	yes	(see Para. 7)
14	Dispute Settlement	**no**	All articles of the GATT are subject to the procedure of the DSU.

Chart 6.11: Articles of the Agreement on Safeguards and their adoption in Article XIX(rev)

6.2.6 The interaction of the revised Safeguard Clause and the violation instrument

In this subsection, two questions will be answered. Firstly, since both the violation instrument and the revised Safeguard Clause have no prerequisites, is the latter simply a new means of realising the substance of the former? In other words, does the revised Safeguard Clause legalise what has been condemned as illegal in the past? Secondly, what would happen to the number of violations once the revised Safeguard Clause has been introduced?

As to the first question, the answer is *no*. While the use of the violation instrument need not respect any legal principle of the world trading order, the revised Safeguard Clause would be subordinated to MFN treatment and to the prohibition of quantitative restrictions (or other non-tariff measures). Furthermore, any import restriction under the revised Clause would have to be notified in advance, which is in contrast to restrictions under the violation instrument. In this sense, while both instruments provide unconstrained trade policy flexibility, only the use of the revised Safeguard Clause respects some essential rules. In terms of the theoretical framework introduced in Subsection 6.2.1, the revised Safeguard Clause would exclusively be used under exceptional political circumstances, due to the trade compensation requirement. This claim cannot be made for the violation instrument according to its current design: if the reputational effect were not strong enough, violations could be expected under normal and exceptional political circumstances.

This brings me to the second question. The revised Safeguard Clause is intended to replace current action under antidumping and countervailing duty law.[366] However, can it be successful in this replacement strategy? What can prevent antidumping and countervailing duty action from henceforth being replaced by a more frequent use of the violation instrument? To begin with, note that it would have been possible in the past already to use the violation instrument instead of antidumping or countervailing duty action. This has not been done regularly, as the impressive numbers on the use of antidumping and countervailing duties confirm. Obviously, the negative reputational

[366] It also replaces action under the current Article XIX GATT and the Agreement on Safeguards, to the extent that they (1) suspend the compensation requirement for three years in the case of absolutely rising imports and (2) allow exceptions to the MFN principle and to the prohibition of quantitative restrictions.

effect of violations ensures that the latter are not seen as a *perfect* substitute for the two lawful trade remedies.

However, governments would be even more discouraged to resort to the violation instrument if they were not able to change the balance of market access concessions. This could be achieved by laying down mandatory compensation as an integral part of the violation instrument.[367] Since an effective enforcement of compensation would only be possible *after* the DSB has made a decision, compensation could be afforded retroactively. Article 22:1 and :2 DSU would have to be modified as follows:

Article 22:1(rev) and :2(rev) DSU

Compensation and the Suspension of Concessions

1. *(a) Trade compensation shall be provided retroactively for the nullification or impairment which has accrued from the date of request for consultations until the recommendations and rulings of the DSB have to be implemented. Compensation shall be consistent with the agreements covered.*

   (b) In addition, prospective trade compensation shall be provided for the enduring nullification or impairment in the event that the recommendations and rulings of the DSB are not implemented within a reasonable period of time. However, compensation is not preferable to full implementation of a recommendation to bring a measure into conformity with the agreements covered.

2. *(a) In respect of retroactive compensation pursuant to the provisions of Paragraph 1(a) of this Article, the Member concerned shall, immediately after the decision of the DSB has been made, enter into negotiations with any party having invoked the dispute settlement procedures, with a view to developing a mutually acceptable solution. If no satisfactory compensation has been agreed within 20 days, the matter shall be referred to arbitration. Such arbitration shall be completed within 60 days and shall be binding. If the Member concerned refuses to follow the arbitration award, any party having invoked the dispute settlement procedures may request*

[367] Remember from the preceding chapter that there are suggestions by a number of observers to give compensation in the DSU a more prominent role.

authorisation from the DSB to suspend the application to the Member concerned of concessions or other obligations under the agreements covered.

(b) If the Member concerned fails to bring the measure found to be inconsistent with a covered agreement into compliance therewith or otherwise comply with the recommendations and rulings within the reasonable period of time determined pursuant to Paragraph 3 of Article 21, such Member shall, if so requested, enter into negotiations with any party having invoked the dispute settlement procedures, with a view to developing mutually acceptable prospective compensation pursuant to the provisions of Paragraph 1(b) of this Article. If no satisfactory compensation has been agreed within 20 days after the date of expiry of the reasonable period of time, the matter shall be referred to arbitration. Such arbitration shall be completed within 60 days and shall be binding. If the Member concerned refuses to follow the arbitration award, any party having invoked the dispute settlement procedures may request authorisation from the DSB to suspend the application to the Member concerned of concessions or other obligations under the agreements covered.

The revised text of Article 22:1 and :2 DSU envisages 20 days for the negotiation of compensation. It corresponds to the 20 days in the current Article 22:2 DSU. This time-frame has been criticised for being too tight in order to achieve a useful result.[368] However, the reason for this critique is rooted in the fact that there has been no incentive in the past for the defendant to enter into serious discussion on compensation. This is different under the revised article: the 20-day period would now be followed by binding arbitration. This supports the presumption that defendants would start to take the 20-day period more seriously than under the current regime.

The retroactive compensation liability according to Article 22:1(a)(rev) should also be taken into account when determining the level of retaliation in case the defendant refuses to afford compensation. This could be done by modifying Article 22:4 DSU:

[368] See the *Contribution of the EC and its Member States to the Improvement of the WTO Dispute Settlement Understanding*, dated 13 March 2002, Document No. TN/DS/W/1, part II.B.

Article 22:4 (rev) DSU

4. The level of the suspension of concessions or other obligations authorised by the DSB shall be equivalent to the level of the nullification or impairment. For the calculation of the level of suspension of concessions or other obligations, the nullification or impairment that has accrued since the date of request for consultations shall also be taken into account.

If both the revised Safeguard Clause and the violation instrument required full compensation, there would no longer be any temporary protection under normal political circumstances. Furthermore, under exceptional political circumstances, the revised Safeguard Clause would in general be the preferred instrument due to the absence of negative reputational effects. The government would resort to violations only if the reputational effects were outweighed by the benefit of introducing import restrictions in non-observance of MFN treatment and the prohibition of non-tariff barriers.

6.2.7 The role of the DSU under the revised Safeguard Clause

Under the revised Safeguard Clause, the DSU is not intended to deter temporary protection *per se*. Instead, the Understanding would have to ensure that any temporary import restriction respects the rules of Article XIX(rev) GATT. It has been argued that an arbitrator could help to determine the proper value of full compensation in response to a safeguard measure. However, a precondition for this determination would be that there is no disagreement about the import restriction itself. Imagine a dispute scenario in which the defendant has not notified the use of Article XIX(rev) and actually denies the allegation that imports have been restricted. Such a denial is common and has been an important ingredient of many disputes under the WTO dispute settlement procedure. In reaction to this denial, the negatively-affected government(s) has (have) to follow the procedure outlined in the DSU. If no mutually-acceptable solution can be found in advance, the DSB would finally adopt a report issued by a panel or by the Appellate Body.

In the past, panels and the Appellate Body have regularly refrained from making specific suggestions. Although being allowed to devise such suggestions – and indeed being

recommended to do so[369] –, they have rarely gone beyond "standard recommendations". In those cases in which an illegal deviation from initial concessions was confirmed, they just recommended that the defendant bring the respective measure into conformity with his obligations under the WTO agreements.[370] However, such a recommendation has a different meaning under the revised Safeguard Clause: "conformity" explicitly includes the temporary maintenance of the import restriction, but in accordance with the conditions of Article XIX(rev) GATT. Therefore, the defendant government would have free choice between two alternative means of compliance. The first one is to withdraw the import-restricting measure. Since the measure had not been notified under Article XIX(rev), it represented a violation: retroactive compensation would be required. The second alternative for the defendant is to maintain the import restriction, but follow the rules of Article XIX(rev). In addition to retroactive compensation for the past violation, prospective trade compensation would be owed. Furthermore, the measure would have to respect the MFN clause and consist of a tariff.

What would happen if the defendant refused both alternatives? Chapter 4 demonstrated that a retaliatory suspension of concessions is the only effective means of enforcement. In accordance with the preceding subsections, the level of the suspension of concessions would have to reflect not only the prospective maintenance of the import-restricting measure, but also the refusal to afford retroactive compensation. In other words, the level of suspension would have to be higher than what has been authorised by the DSB in the past. Note that this corresponds to the adjusted Ethier model in Chapter 4: a retroactive suspension of concessions replicates Ethier's *instant* retaliation.

In conclusion, conceding more significance to the provision of compensation in response to temporary protection does not mean that compensation can replace the suspension of concessions. In other words, compensation and retaliation are not perfect substitutes, although some authors seem to believe just that.[371] When a country refuses to offer

[369] See e.g. Hoekman and Mavroidis (2000).
[370] See Pauwelyn (2000).
[371] See, for example, De Bièvre (2002), p. 1011f, who boldly writes: "If the instrument [of retaliation] does not always bring about compliance, how then could enforcement work *were we to drop it entirely*? Would the *abolition of the retaliation provision* not take the teeth out of the WTO dispute settlement system and cause routine disputes to drag on again as they did under the GATT? Would the case-by-case enforcement system not quickly unravel to the point of making private industry disinterested to provide governments with information on non-compliance? The retaliation weapon could be turned around to produce the effect of compliance and have beneficial effects on trade. *It*

compensation, there is no way of coercing it to do so. Only a suspension of concessions is self-enforcing.

However, despite the fact that the provision of compensation can never be guaranteed, its prominence in the world trading order would significantly increase if Article XIX(rev) GATT replaced both antidumping and countervailing duty action. The only way of avoiding compensation in response to a temporary import restriction would then be to violate WTO rules. Although Chapter 3 showed that violations are a widely-used flexibility instrument, the fact that they entail illegal behaviour and negative reputational effects will always make them an unattractive last resort of government behaviour.

could be replaced by the obligation to offer compensatory liberalisation in another sector." Emphasis added.

7 Conclusion

7.1 Final remarks

A new round of multilateral trade negotiations was started after the Fourth Ministerial Conference held in Doha in November 2001. There have already been a multitude of meetings, generating an impressive number of proposals for reform.[372] Nonetheless, scepticism with regard to the bold aim of concluding a substantial liberalisation package by 1 January 2005 (as scheduled by the Doha Ministerial Declaration) is justified. The complete failure of the Fifth Ministerial Conference in Cancún in September 2003 brought about little encouragement.

Observers of the current trade negotiations have come up with a variety of explanations for the difficulties experienced.[373] At the moment, the general geopolitical situation after September Eleven, the transatlantic tensions, the dissension about agriculture, or the often cited ditch between the developed and developing world are ranking high in the list of stumbling blocks for success. All of them merit attention. On the other hand, none of them should be overvalued, as they might be of a temporary nature only. Being impressed by the reduction in tariff barriers since 1947, but judging the remaining level of protectionism as being substantial, one is tempted to ask if the main obstacle for a smooth process of progressive liberalisation is not rather of a *structural* nature. Under such a perspective, the key problem might not exist in the diverging interests among members over which sectors to liberalise first. Instead, the problem could be hidden in the current institutional design of the world trading order.

This study has shed light on an important aspect of this institutional design. No one doubts that the rules on trade policy flexibility are tightly correlated with the effective level of cross-border market access. However, it is no small matter to establish a design that is "optimal" in the sense of promoting international trade and global social welfare. There are trade-offs that cannot be circumvented, and there is empirical evidence that is unfortunately not clear-cut. The aim of this study has been to offer a broad perspective on the institutional design of flexibility in the world trading order. The core elements have

[372] A recommendable source for keeping track of the latest developments is the *Bridges Weekly News Digest*, see http://www.ictsd.org/weekly.

been a descriptive analysis of the current regime; a thorough look at and a critique of existing suggestions for reform; and a comparison of these suggestions with an alternative approach that is intended to reduce the number of temporary import restrictions without impairing the ability of governments to decide when to protect import-competing industries.

* * *

Barbara Koremenos starts a recent paper with the question: "How can the corsets of international agreements be made more flexible and therefore more robust? Or, in the words of Jon Elster, how can Ulysses be loosely bound to the mast?" [374]

The institutional design of flexibility is both an essential and a highly complex element of the world trading system. Trade policy flexibility, as understood in my study, provides governments with the ability to decide on temporary import restrictions that are in deviation from trade concessions internationally agreed upon. In a first-best world, no such deviations would occur – and trade liberalisation would not be affected. However, owing to the needs of national politics, this is impossible. As long as organised interests are able to gain a privileged access to the political process, social welfare will not be the sole ambition of the government. Therefore, second-best mechanisms have to be found. These should allow a government to give in to the pressure of a particular lobby group *when this pressure is irresistible anyway*, but ensure that an appropriate price is paid in return. This price has two different functions. Firstly, it compensates negatively-affected contracting parties, thereby sustaining their continued interest in co-operation. Secondly, it deters the government from introducing temporary protection whenever there is no political coercion to do so.

While there is a widespread perception that a completely rigid world trading system would not be viable, the institutional design of flexibility is a heavily-disputed topic. A refutable presumption of this study has been that the formal stipulation of flexibility would be useless if this flexibility were conditioned on economic criteria. I have argued that the possibility of deviating from initial concessions cannot satisfy self-interested governments as long as this possibility is linked to arbitrary variables defining the state of

[373] Specific reasons for the failure of Cancún can be found in Hauser (2003) or Evenett (2003).
[374] Koremenos (2001a), p. 289.

the national economy. Since political pressure is not necessarily defined by economic variables, the inclusion of these variables in a trade agreement is against the interest of a government which fears that its fortune could someday depend on the support from a particular import-competing sector.

My solution for the reform of the institutional design of flexibility envisages that temporary protection can be implemented independently of prevailing economic circumstances. While this freedom seems to be a drastic change compared to the current regime, the experience with antidumping should make clear that this is not the case. Today already, governments are virtually free to restrict imports because the prerequisites of antidumping are extremely low. It would only be consequential to forget the discussion about unfair trade and admit that antidumping is nothing other than a safeguard measure with rudimentary prerequisites. Introducing a modified Safeguard Clause that completely dispenses with prerequisites is not at all revolutionary: it is rather a question of honesty.

What is more, combining such a Safeguard Clause with mandatory compensation for negatively-affected trading parties (and endowing the violation instrument with the same requirement) is not revolutionary either. While compensation has been a neglected concept in reality, it is well-rooted in the text of most international trade agreements. Compensation is explicitly mentioned in the Agreement on Safeguards, and it is part of the DSU. Furthermore, various authors have suggested giving compensation a more prominent standing in the world trading order. While these suggestions exclusively focus on dispute settlement, there is no plausible reason why compensation should not become an inherent feature of safeguard action as well.

In sum, the proposal for a modified Safeguard Clause that replaces both the existing Article XIX GATT and the instruments of antidumping and countervailing duties must not be flatly rejected on feasibility grounds. Nonetheless, I admit that there is a significant discrepancy between today's regime and my suggestion for a new institutional design. This discrepancy can hardly be overcome by a once-and-for-all endeavour. The history of the world trading order since 1947 shows that any progress has to be made in small steps. However, these steps have to go in the right direction, otherwise they are not sustainable.

What could intermediate steps towards my new regime look like? One possibility would be to introduce the modified Safeguard Clause, but maintain antidumping and

countervailing duties for a transitional period. During this period, antidumping and countervailing duty activities would remain at an unchanged level, since the two instruments do not require compensation. In a second step, the prerequisites of antidumping and countervailing duties could be progressively raised – just as detailed by many existing suggestions for reform (see Chapter 5). This progressive rise of prerequisites should now be acceptable to governments, since their trade policy flexibility is not impaired due to the modified Safeguard Clause. At the same time, the violation of WTO agreements would have to entail full (and retroactive) compensation in order to avoid a shift from lawful trade remedies towards this illegal instrument. In a third step, antidumping and countervailing measures could be phased out.

7.2 Future research

While it has been shown that trade policy flexibility is an essential feature of the world trading order and a precondition for continuous multilateral liberalisation, there are examples of regional integration in which intra-regional liberalisation is sustainable without intra-regional trade policy flexibility. For instance, governments of EC member states have virtually no instrument for (temporarily) protecting individual home markets against intra-regional imports. Does this impair my key assumption that governments are not willing to give up trade policy flexibility?

I can best defend my assumption by pointing to the differences between the WTO and the EC. Firstly, individual EC member states still have the option to lobby in Brussels for temporary restrictions against *extra*-regional imports, and they definitely do so. Secondly, while the WTO is a mere trade agreement, the EC has rapidly become more: there is a strong desire to realise a deep economic and political integration. In spite of all divergences, EC members share a broad set of common interests and goals, and they have a similar level of economic development. Under such circumstances, it is presumably easier for governments to transfer trade policy competencies to a supranational level and thereby lose the ability to make autonomous decisions. Future research might analyse these differences more thoroughly in order to single out the preconditions for a successful abandonment of trade policy flexibility within the scope of deeper integration.

My simple theoretical framework of Section 6.2.1 offers further starting-points for future research. For example, there are probably many factors leading to what has been termed

"exceptional political circumstances". These factors are exogenous in the theoretical framework, and it would therefore be interesting to extend the framework by endogenising at least some of them. For example, would a regime that has no prerequisites for temporary import restrictions, but requires full compensation instead, affect the frequency of exceptional political circumstances? On the one hand, the abolition of prerequisites might strengthen the influence of import-competing interest groups, since there would *ex ante* be no situation any more where the international trade agreement formally prohibits a temporary import restriction. On the other hand, the *Damocles sword* of compensation might split the import-competing industry and reduce its clout, thereby lowering the frequency of exceptional circumstances. Future research should clarify this issue.

Another research topic that merits attention is the design of compensation. The fact that compensation has played a minor role in the past is not only due to a general antipathy with the concept as such, but also due to the difficulties in implementation. Anderson (2002), focusing on compensation in the framework of dispute settlement, considers three implementation problems. Firstly, timely arbitration is not guaranteed. Secondly, the MFN requirement means that unaffected countries would also profit from the defendant's market access concessions: they would be compensated while not having incurred any harm. Thirdly, compensation provides the defendant with greater control of the procedures.

As regards the first and the third problem, my proposed modifications of Article XIX GATT and the DSU should ease the implementation of compensation, due to the possibility of binding arbitration. What remains, however, is the second problem. If compensatory market openings are for everyone, this does not conflict with social welfare considerations, but it is difficult to digest from a government perspective. In order to overcome this problem, future research should consider mechanisms that allow the provision of compensation on an MFN basis, but ensure that those trading partners which are negatively affected by the temporary protection grab the lion's share of the additional market access opportunities. While such a tightrope walk is not easy, the successful negotiations on compensation in the fifties and sixties (see Chapter 3) show that it should be feasible.

Compensation is not only discussed in international trade law circles, but also in other areas of multilateral co-operation. For example, it is an issue in the case of expropriation of foreign investment.[375] Furthermore, it is debated in respect of cross-border environmental damage[376] and of the consequences of war.[377] Future research could make apparent to what extent the experience with compensation in these areas is useful for the design of compensation in the framework of the WTO.

Last but not least, a general statement about the starting-point for future research can be made. While the multilateral trading order is unique in the sense that any empirical dataset about its functioning can only be a time series, regional integration agreements are numerous and therefore offer the possibility of both time-series *and* cross-sectional studies. Chart 7.1 shows the number of new regional integration agreements over time. In total, 245 regional integration agreements were notified between 1948 and 2002, and 169 of them are still in force.

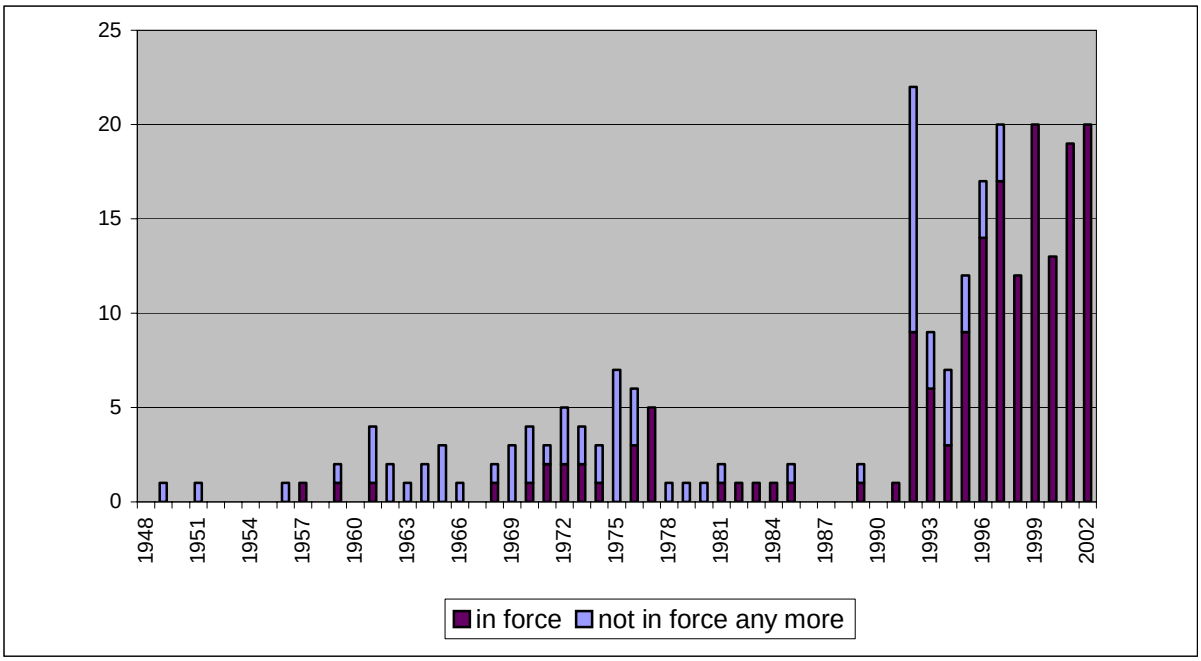


Chart 7.1: New regional integration agreements 1948-2002[378]

As mentioned above, multilateral co-operation is not the same as regional integration. Nonetheless, the empirics of regional trade agreements could help to gain an

[375] For a discussion see the survey book of Sornarajah (1994).
[376] See e.g. the collected papers in Wetterstein (1997).
[377] See e.g. Gattini (2002), discussing the UN Compensation Commission.

understanding of various issues of the institutional design of flexibility that are also relevant on a multilateral level. Indeed, there are studies which have done exactly that. Sagara (2002), for instance, performs a comprehensive analysis on trade remedies in regional settings. Among other findings, he shows that many regional agreements have trade compensation devices in their Safeguard Clause design.[379] Future studies could be more explicit on the question as to what extent trade policy flexibility contributes to the success or failure of regional integration. The results would be useful for the multilateral level as well.

[378] Data source: WTO website. Only notified agreements are shown.

[379] These agreements include the EFTA-Singapore Free Trade Agreement, the EC-Mexico Free Trade Agreement, the NAFTA, the Canada-Chile Free Trade Agreement, and the Agreement between the Republic of Singapore and Japan for a New-Age Economic Partnership.

8 Appendix

8.1 Country classification based on Miranda, Torres and Ruiz (1998)

(1) Developed countries:

Australia, Canada, EC member states (15), Japan, Liechtenstein, New Zealand, Norway, South Africa, Switzerland, United States

(2) Transition countries:

Armenia, Azerbaijan, Belarus, Bosnia Herzegovina, Bulgaria, China, Croatia, Cuba, Czech Republic, Estonia, Georgia, Hungary, Kazakstan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russian Federation, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, Vietnam

(3) Developing countries:

All remaining countries

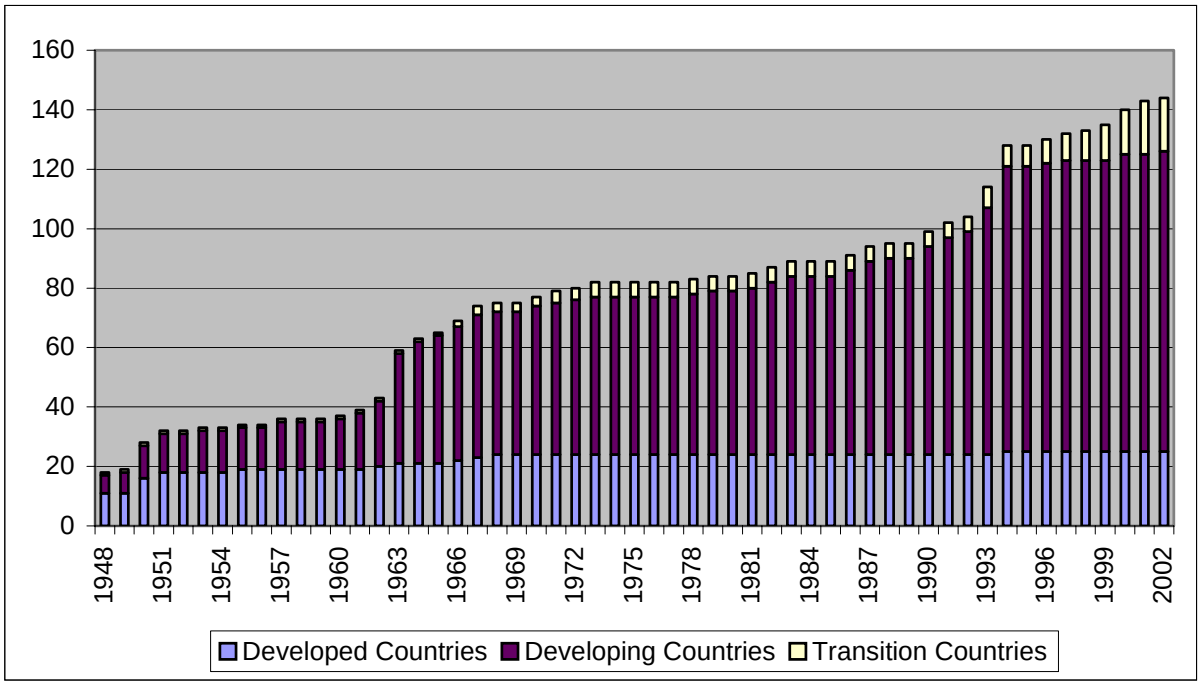
8.2 Section headings of the Harmonised System (HS)

Section	Description
I	Live animals; animal products
II	Vegetable products
III	Animal or Vegetable Fats and Oils and Their Cleavage Products; Prepared Edible Fats; Animal or Vegetable Waxes
IV	Prepared Foodstuffs; Beverages, Spirits and Vinegar; Tobacco and Manufactured Tobacco Substitutes
V	Mineral products
VI	Products of the Chemical or Allied Industries
VII	Plastics and Articles Thereof; Rubber and Articles Thereof
VIII	Raw Hides and Skins, Leather, Furskins and Articles Thereof; Saddlery and Harness; Travel Goods, Handbags and Similar Containers; Articles of Animal Gut (Other than Silk-Worm Gut)
IX	Wood and Articles of Wood; Wood Charcoal; Cork and Articles of Cork; Manufactures of Straw, of Esparto or of Other Plaiting Materials; Basketware and Wickerwork
X	Pulp Of Wood or of Other Fibrous Cellulosic Material; Recovered (Waste and Scrap) Paper or Paperboard; Paper and Paperboard and Articles Thereof
XI	Textiles and Textile Articles
XII	Footwear, Headgear, Umbrellas, Sun Umbrellas, Walking-Sticks, Seat-Sticks, Whips, Riding-Crops and Parts Thereof; Prepared Feathers and Articles Made Therewith; Artificial Flowers; Articles of Human Hair
XIII	Articles of Stone, Plaster, Cement, Asbestos, Mica or Similar Materials; Ceramic Products; Glass and Glassware
XIV	Natural or Cultured Pearls, Precious or Semi-Precious Stones, Precious Metals, Metals Clad with Precious Metal and Articles Thereof; Imitation Jewellery; Coin Thereof; Imitation Jewellery; Coin

XV	Base Metals and Articles of Base Metal
XVI	Machinery and Mechanical Appliances; Electrical Equipment; Parts Thereof; Sound Recorders and Reproducers, Television Image and Sound Recorders and Reproducers, and Parts and Accessories of Such Articles
XVII	Vehicles, Aircraft, Vessels and Associated Transport Equipment
XVIII	Optical, Photographic, Cinematographic, Measuring, Checking, Precision, Medical or Surgical Instruments and Apparatus; Clocks and Watches; Musical Instruments; Parts and Accessories Thereof
XIX	Arms and Ammunition; Parts and Accessories Thereof
XX	Miscellaneous manufactured articles
XXI	Works of Art, Collectors' Pieces and Antiques

The Harmonised System is a six-digit commodity classification that has been developed under the auspices of the World Customs Organisation. Some countries have extended it to eight digits for export purposes. The table is taken from the WTO website.

8.3 Evolution of WTO membership



Data source: WTO website.

8.4 Text of the current Safeguard Clause (Article XIX GATT)

Emergency Action on Imports of Particular Products

1. (*a*) If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions, any product is being imported into the territory of that contracting party in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the contracting party shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession.

   (*b*) If any product, which is the subject of a concession with respect to a preference, is being imported into the territory of a contracting party in the circumstances set forth in subparagraph (*a*) of this paragraph, so as to cause or threaten serious injury to domestic producers of like or directly competitive products in the territory of a contracting party which receives or received such preference, the importing contracting party shall be free, if that other contracting party so requests, to suspend the relevant obligation in whole or in part or to withdraw or modify the concession in respect of the product, to the extent and for such time as may be necessary to prevent or remedy such injury.

2. Before any contracting party shall take action pursuant to the provisions of paragraph 1 of this Article, it shall give notice in writing to the CONTRACTING PARTIES as far in advance as may be practicable and shall afford the CONTRACTING PARTIES and those contracting parties having a substantial interest as exporters of the product concerned an opportunity to consult with it in respect of the proposed action. When such notice is given in relation to a concession with respect to a preference, the notice shall name the contracting party which has requested the action. In critical circumstances, where delay would cause damage which it would be difficult to repair, action under paragraph 1 of this Article may be

taken provisionally without prior consultation, on the condition that consultation shall be effected immediately after taking such action.

3. (*a*) If agreement among the interested contracting parties with respect to the action is not reached, the contracting party which proposes to take or continue the action shall, nevertheless, be free to do so, and if such action is taken or continued, the affected contracting parties shall then be free, not later than ninety days after such action is taken, to suspend, upon the expiration of thirty days from the day on which written notice of such suspension is received by the CONTRACTING PARTIES, the application to the trade of the contracting party taking such action, or, in the case envisaged in paragraph 1 (*b*) of this Article, to the trade of the contracting party requesting such action, of such substantially equivalent concessions or other obligations under this Agreement the suspension of which the CONTRACTING PARTIES do not disapprove.

(*b*) Notwithstanding the provisions of subparagraph (*a*) of this paragraph, where action is taken under paragraph 2 of this Article without prior consultation and causes or threatens serious injury in the territory of a contracting party to the domestic producers of products affected by the action, that contracting party shall, where delay would cause damage difficult to repair, be free to suspend, upon the taking of the action and throughout the period of consultation, such concessions or other obligations as may be necessary to prevent or remedy the injury.

Acronyms

EC	European Communities
DSB	Dispute Settlement Body
DSU	Dispute Settlement Understanding
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
G-H	Grossman-Helpman
GSP	Generalised System of Preferences
HS	Harmonised System
ITO	International Trade Organisation
IMF	International Monetary Fund
LDC(s)	Least Developed Country (Countries)
MFN	Most Favoured Nation
OMAs	Orderly Marketing Arrangements
PPMs	Process and Production Methods
US	United States of America
VERs	Voluntary Export Restraints
WTO	World Trade Organisation

Table of Charts

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Curriculum Vitae

Since 2004	*McKinsey & Company*, Zurich Business Consultant
2000-2004	*Swiss Institute for International Economics and Applied Economic Research* (SIAW-HSG), St. Gallen Research Associate
2000-2001	*University of St. Gallen* Doctoral program in Economics
1995-2000	*University of St. Gallen* Studies in Economics and Finance
1987-1995	*Liechtensteinisches Gymnasium*, Vaduz (FL)
1982-1987	*Primarschule Triesen* (FL)
1975	Born in Grieskirchen (A)