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Economic Sanctions in the GATT/WTO World Trading System

This paper will focus on experience with economic sanctions[1] under the GATT/WTO system. This is not to ignore the experience with economic sanctions in other areas, particularly for foreign policy reasons, but those are ably covered elsewhere.[2]

The GATT/WTO dispute settlement system is interesting because it represents, conceptually, a third stage of the use of economic sanctions. Economic sanctions have long been used in conjunction with armed warfare – e.g., the British blockade of Napoleon. Indeed, a blockade was considered an act of war. During the Cold War there was an increased use of economic sanctions as a substitute for hostilities. The U. S. embargo of Cuba comes to mind as an example (But also as a warning. Whatever economic sense it might have or might not have had, it instead has become more useful for other purposes, specifically electoral ones in the states of Florida and New Jersey). Economic sanctions in the GATT/WTO system – decided after a neutral judicial process, rather than multilateral diplomacy – have quite a different function. They are the only "stick" legally available to a primitive quasi-governmental organization made up of sovereign nation states, with a sprinkling of customs unions and customs territories with varying attributes.

I. Forty-Seven Years of Evolution under the GATT

The 1947 GATT did not itself contain any provision for economic sanctions or, indeed, any provision at all for dispute settlement beyond the requirements for consultations in Articles XXII and XXIII. Yet despite this, the GATT Contracting Parties developed a quite judicialized (and quite active) dispute settlement mechanism. This activity has been thoughtfully analyzed by Professor Hudec.[3]

The key point for this paper is that Hudec's analysis showed that the GATT was quite effective – by his calculation, 88% of the cases were resolved in a satisfactory manner – with virtually no use of economic sanctions.

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[1] "Economic sanctions" are defined here to mean barriers put up by a country to another country's imports.

[2] See, for example, U. S. perspectives in: *Barry E. Carter,* International Economic Sanctions: improving the haphazard U. S. legal regime (Cambridge, 1988); and *Gary C. Hufbauer/Jeffrey J. Schott/Kimberly Ann Elliott,* Economic Sanctions Reconsidered: 2 d Edition (Washington, 1990).

[3] *Robert E. Hudec,* Enforcing International Trade Law: The Evolution of the Modern GATT Legal System (London, 1988).

Economic sanctions were authorized in the GATT system only once, when the Netherlands won a case against the United States for U. S. barriers to Dutch cheese. The Netherlands was authorized to impose economic sanctions on U. S. wheat, but, sensibly, chose not to raise the price of Dutch bread to do so. Economic sanctions were also agreed outside the formal GATT system, in 1964, following the Common Market's increase in tariffs on U. S. poultry. In retaliation, the U. S. raised tariffs on *inter alia* (German) Volkswagen vans and (French) cognac, creating a textbook example of the perils of economic sanctions in the international trade area. The European barriers to U. S. poultry imports remained in place, so U. S. chicken farmers did not benefit, while the U. S. sanctions have harmed innocent bystanders (French cognac producers, and not only Volkswagen, but also light truck producers who were not initially targeted but later wanted to ship products in the same tariff lines, starting with British manufacturers and then Japanese ones), and also arguably harm any Volkswagen-van-buying, cognac-sipping U. S. chicken farmers! Worse yet, the 25 % tariff imposed by the U. S. on light trucks was useful to U. S. light truck manufacturers, and remains in place to this day, although it is now ten times higher than the average U. S. applied tariff.

Why did the GATT system work so well without the application of economic sanctions to back up the decisions? In part, because the career services in GATT Contracting Parties' bureaucracies right into the 1960's continued to be dominated by some of the original creators of the system, who understood the unwritten rule that the purpose of the GATT was to lower tariffs, not raise them. Only with the Tokyo Round in 1979 and the Uruguay Round in 1994 did GATT negotiations lead to *increases* in protection, mainly through more protectionist anti-dumping and safeguard rules, rather than negotiated reductions in protection. At least equally important was the fatal flaw of GATT dispute resolution: any Contracting Party – including the losing Party – could "block" the decision, so that a losing party which feared retaliation/economic sanctions could always block the decision and avert the sanctions. It is a tribute to the strength of the trade liberalizing aspect of the system that so many decisions were instead complied with rather than blocked.

II. The WTO Dispute Settlement Mechanism

The keystone of the World Trade Organization agreed in the Uruguay Round of GATT negotiations was reform of the dispute settlement mechanism, and, in particular, the reversal of the "blocking" procedure so that decisions of a panel (or the new Appellate Body) automatically were adopted by the Members unless all of them disagreed – i.e., it was impossible to block a decision unless the *winning* party agreed to forego its victory. This change, more than any of the others, led to a multiplication in disputes, since disputes which were formerly certain to be blocked could now be brought. From January 1, 1995, through December 13, 2002, there have been 275 cases, a rate almost ten times higher than under the GATT. As with the GATT, eco-

nomic sanctions are not usually needed to induce compliance with the rulings. To date, economic sanctions have been applied by the WTO Members in only two cases – *Bananas* (by the U. S. against EU exports) and *Beef* (by the United States and Canada against EU exports). In *Bananas*, the sanctions led the EU to comply. In other cases, sanctions have been authorized but not used. In *Aircraft*, Brazil and Canada found themselves in a standoff (each was authorized to retaliate against a significant amount of bilateral trade, so neither did – but instead both continued with practices that others found objectionable), and the EU in *FSC* has chosen not to apply the $ 4 billion in economic sanctions against the U. S. authorized by the WTO Members (although the EU has not hesitated to use it as leverage in other disputes). In *Broadcast Music*, the U. S. has agreed to pay the relatively small amount of money at stake – about $ 2 million – to the EU for distribution to the injured party. Apparently there were negotiations of the same sort going on between Ecuador and the EU concerning *Bananas* after Ecuador procured the rather innovative authorization from the WTO to retaliate against European intellectual property rights.[4]

Thus, only one economic sanction under the WTO remains in effect: the $ 116 million in tariffs applied to European agricultural and industrial exports by the United States in return for the WTO-inconsistent ban on imports of U. S. *Beef* fed with hormones found to not cause risk of harm as food. To date, the EU has shown no sign of lifting the ban, arguing there is consumer distrust because of the failures of European regulators with BSE, dioxin, FMD, and AIDS-tainted blood. Yet the sanctions do no good for U. S. beef producers, since there are virtually no EU beef imports to stop. This repeats the classic standoff from the 1964 "Chicken War" described above and underlines both the possible futility and certain destructiveness of economic sanctions within the GATT/WTO system.

The other reason for the low incidence of economic sanctions in the GATT/WTO system is the realization by the Member governments that they all live in glass houses – governments are reluctant to push other governments too far for fear of being subject to the same sort of treatment. The result is, in effect, a "3-year pass." Virtually every significant WTO Member including at least Argentina, Australia, Canada, Brazil, the EU, the U. S., Japan, Korea and many others have taken actions knowing that they were inconsistent with the WTO rules, but secure in the knowledge that they could "get away with it" – because economic sanctions in the WTO to date have only been taken prospectively, so there was no disincentive to "stall" during the dispute settlement process or to delay compliance as long as possible. While three years may or may

[4] Poorer developing countries have long complained that they cannot effectively apply economic sanctions to large developed countries. For a small country to raise tariffs against a large country such as the U. S. or the EU is to raise the small country's costs of imports, which those countries claim to be either basic necessities of life or necessary inputs for local industry, so raising costs is not sensible. At the same time, the impact on the larger countries is so small as to have no effect, except to irritate a powerful neighbor. While this may have been true under the GATT system, where retaliation was limited to imports of goods, Ecuador has shown that under the WTO, the logic is quite different, since authorization to reduce royalty payments on intellectual property lowers the smaller country's costs, at least temporarily, although the fear of irritating a larger power still remains.

not be the "comfort zone" for WTO Member governments – an implied period of delay not found in the rules, but which each Member government is willing to grant the others – it is far longer than the time horizon for many of the private actors – companies, farmers, and so on – which are the purported beneficiaries and users of the WTO trading system.

This combination of the futility/destructiveness of the economic sanctions used in the WTO system, taken with the absence of any component of those sanctions which would discourage violation of the rules, or encourage prompt compliance, has led to a "slow crisis" in WTO dispute settlement. More and more governments more and more frequently are tempted to take the convenient if WTO-inconsistent route for the "three-year pass", a tendency which would be exacerbated by the understandable reluctance of governments to use retaliation (the only permitted sanctions). Consequently, this is a topic to be discussed in the current Doha "Round" of WTO negotiations. To date, only Mexico has raised these issues, while other Members have focused on the need for some mid-course reforms, including full time professional panelists, a full time Appellate Body, some revisions of the time limits to give the Appellate Body more time (this could be done by recognizing the consultation requirements as a necessary "action-forcing event" to stimulate settlement discussions but requiring only 20 days rather than 60, for example), and the package of amendments to the DSU which was put together for the Seattle Ministerial but never adopted.

Beyond those and mid-course changes, however, reforms are needed during the forthcoming Doha Round to deal with two more deep-seated problems which are becoming apparent.

1. Non-compliance with WTO decisions

To date there has been direct non-compliance with WTO decisions in at least three sets of cases: the EU in the cases brought by the U. S. and Canada on *Beef* (leading to retaliation against EU by both countries), the Brazil/Canada *Aircraft* cases (with a variety of actions, but no formal retaliation), and *Bananas*, (with retaliation by the U. S., since lifted after negotiations, and recent negotiations between Ecuador and the EU). While the number of non-compliance situations is not large (although it omits impending non-compliance in cases such as *U. S.-FSC* and *U. S.-1916 Act)*, the use of retaliation in two cases, and threats in others, has underlined that the "menu" of remedies available in WTO cases is very restricted. Absent compliance, the only other two items on the menu appear to be negotiated compensation (i.e., trade liberalization in other areas by the losing party), or retaliation. The former option is unlikely in most cases. In countries with generally low tariffs such as the U. S., the only high tariffs which could be used as compensation are those which benefit politically influential producers (that is why they are high), while countries with high tariffs are unlikely to offer the truly painful tariff cuts which would be of interest to a winning party. Retaliation is far worse – the purpose of the WTO is to lower barriers, not raise them, yet

retaliation offsets one WTO inconsistent action with another. Too many retaliations would leave the WTO commitments, and their MFN nature, in tatters.

There is an obvious need to add items to the menu. Public international law is replete with less harmful mechanisms than retaliation (e.g., the loss of certain voting rights in the UN for non-payment of dues). Some of these could be adapted creatively to the WTO system, following key principles such as the need to compensate the true injured party at interest (typically, an exporter in the winning country). This must be done carefully (e.g., monetary compensation – quite common in international practice – must be arranged in a way that does not favor richer countries over poor ones), but there is time enough in the forthcoming negotiations to think these things through.

2. Consensual non-compliance with WTO Rules

Interestingly, the few cases of non-compliance with WTO decisions so far have all involved measures put into effect *before* the WTO was completed (i.e., compliance with WTO rules which had not yet been negotiated was unlikely). Far more corrosive for the future of the WTO as a rule-based system on which exporters can rely is the increasing tendency by large numbers of Members to "game" the WTO by taking measures which are obviously WTO inconsistent, safe in the knowledge – which is often stated or implied – that the WTO-inconsistent measures can be maintained for 2–3 years while the WTO process and its compliance phases are completed. To take an obvious example, some of the obligations for certain developing countries in the TRIPs and TRIMs agreement involved having legislation in place by January 1, 2000. The absence of such legislation was, unquestionably, inconsistent with the WTO, but some affected countries made it clear that they did not much care, because dispute resolution would take several years. This should not be seen as a developing country problem – to the contrary, this is more obviously a problem with large markets such as the EU (*Bananas* III regime) or the U. S. (preliminary countervailing duties on Canadian softwood lumber while negotiating with Canada on measures to restrict lumber exports to the U. S.), or Mexico's imposition of antidumping duties on High Frutose Corn Syrup from the U. S. for more than four years, while losing a WTO panel, WTO Appellate Body decision, and NAFTA Chapter 19 panel. The list of such countries in just six years is already surprisingly long. Over time, the corrosive effect of this approach, if followed by enough Members enough times, will destroy the credibility of WTO rules as ones on which traders and investors can rely. Fixing this problem will require rethinking not only the menu of remedies, as described above, but also their timing. At present, there is no disincentive for countries to delay coming into compliance – to the contrary, there is usually good reason to delay every step. What is needed is some sort of "cost" imposed on the inconsistent country from a fairly early stage – and certainly no later than DSB adoption – as well as retroactive repayment with interest of any illegally collected charges. Of course, the sovereign states which make up the WTO may well decide that they really want a "three-year

pass", and definitely want the ability not to comply with rulings by external judicial bodies. Many will argue convincingly that WTO members will never accept this discipline, but few thought in the early 1980's that all GATT Parties would accept the binding dispute resolution now in the WTO. The alternative is not the disappearance of the WTO – the GATT did not disappear as its dispute settlement system was perceived as blocked – but it will lead to diminished effectiveness and prestige, and a turn to alternatives, possibly through regional trading arrangements.