

Should Export Subsidies be Treated Differently?

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One of the central achievements of the Uruguay Round¹ of trade negotiations was ensuring that disputes concerning almost all WTO provisions are subject to the rules and procedures laid out in the Dispute Settlement Understanding (DSU).² The vast majority of multilateral trade rules are now adjudicated according to identical standards and procedures, a convergence that spawned a burgeoning literature on the normative roots and legal nature of WTO rights and remedies.³ However, this debate only skirts the periphery of a potential bellwether for the future of WTO disputes: the distinctive provisions for export subsidies in the Agreement on Subsidies and Countervailing Measures (SCM).⁴

The SCM carves out unique rules for export subsidies, not shared by other classes of subsidies. It bans such transfers outright, demands that inconsistent measures be withdrawn “without delay”, and authorizes “appropriate countermeasures” if a Member persists in providing

¹ Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, in WORLD TRADE ORGANIZATION, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS (1999). All agreements integrated in the Final Act are available online at http://www.wto.org/english/docs_e/legal_e/legal_e.htm.

² Understanding on the Rules and Procedures Governing the Settlement of Disputes, in WORLD TRADE ORGANIZATION, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS (1999) [hereinafter DSU].

³ The main debate operates on two planes. First, there is the question of whether compliance with WTO Agreements is demanded by an international legal “obligation” or an “elective” on a menu of sovereign choices. The now-classic and often-misunderstood exchange is Judith H. Bello, *The WTO Dispute Settlement Understanding: Less is More*, 90 AM. J. INT’L L. 416 (1996) and John H. Jackson, *The WTO Dispute Settlement Understanding: Misunderstandings on the Nature of Legal Obligations*, 91 AM. J. INT’L L. 60 (1997). The original arguments were clarified in Judith H. Bello, *Book Review*, 95 AM. J. INT’L L. 984, 986-87 (2001) (reviewing JOHN H. JACKSON, THE JURISPRUDENCE OF GATT AND THE WTO) and John H. Jackson, “International Law Status of WTO Dispute Settlement Reports: Obligation to Comply or Option to ‘Buy Out’?” 98 AM. J. INT’L L. 109 (2004). A stauncher defense of the “menu” or “economic” understanding of compliance is Warren F. Schwartz & Alan O. Sykes, “The Economic Structure of Renegotiation and Dispute Resolution in the World Trade Organization,” 31 J. LEGAL STUD. 179 (2002). The second question, deriving from the first, is the purpose of the remedy structure: is it aimed at “inducing” (forcing) compliance or encouraging adjustment and political accommodation? For the former view, see, e.g., Steve Charnovitz, “Rethinking WTO Trade Sanctions,” 95 AM. J. INT’L L. 792, 800-08 (2001) (arguing the purpose of remedies shifted from rebalancing to sanctions when the WTO replaced GATT); Petros C. Mavroidis, “Remedies in the WTO Legal System: Between a Rock and a Hard Place,” 11 EUR. J. INT’L L. 763 (2000) (presuming an inducement purpose from Appellate Body decisions); Sungjoon Cho, “The Nature of Remedies in International Trade Law,” 65 U. PITT. L. REV. 763, 770 (2003-04) (arguing that DSU remedies privileges “consistency and conformity with WTO rules over compensation”). For the latter view, see Robert E. Hudec, “Broadening the Scope of Remedies in WTO Dispute Settlement,” in IMPROVING WTO DISPUTE SETTLEMENT PROCEDURES (Friedl Weiss & Jochem Wiers, eds., 2000), available at <http://www.worldtradelaw.net/articles/hudecremedies.pdf> (recognizing the economics of rebalancing as “fiction” but addressing it to legal and political realities); ROBERT Z. LAWRENCE, CRIMES & PUNISHMENTS? RETALIATION UNDER THE WTO (2003); Wilhelm Kohler, “The WTO Dispute Settlement Mechanism: Battlefield or Cooperation? A Commentary on Fritz Breuss,” 4J. INDUS. COMP. & TRADE 317, 331-32 (2004) (discussing the political economy of rebalancing); Joost Pauwelyn, “Enforcement and Countermeasures in the WTO: Rules are Rules, Towards a More Collective Approach,” 94 AM. J. INT’L L. 335, 339-44 (2000).

⁴ Agreement on Subsidies and Countervailing Measures, in WORLD TRADE ORGANIZATION, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS (1999), art. 4.10 [hereinafter SCM].

a subsidy. Export subsidies, vilified in both the GATT and the Tokyo Round Subsidies Code, are finally subject to a toothsome enforcement mechanism—one that was used to explosive effect in a \$4 billion dispute between the United States and the European Union over Foreign Sale Corporations (FSC).⁵

The peculiar treatment given export subsidies is important to two larger agendas. The first is the banner rationale for the Doha Round, negotiating an agreement which is particularly focused on the needs of developing countries. Developing countries have a particular interest in export subsidies. They have already been involved in WTO disputes over these subsidies as defendants and complainants, and their role is likely to grow over time.⁶ On the one hand, developing countries are important users of export subsidies. Many have used them as a key component of their development strategies. Export processing zones, for example, have proved to be an effective short cut mechanism for relieving producers of domestic institutional constraints.⁷ In the Uruguay Round, however, developing countries agreed to give up their export subsidies by January 1, 2003, including many measures used in export processing zones. At the Doha Ministerial in 2001, a number of developing countries were granted more time to conform with the Uruguay Round requirements. But these extensions are scheduled to end in 2007, and will then be open to challenge.⁸ The *per se* ban on export subsidies, together with the size of

⁵ See Gary Clyde Hufbauer, “The Foreign Sales Corporation Drama: The Last Act?” *International Economic Policy Brief*, No. PB02-10 (2002). For a legal history of the FSC/ETI dispute, see Candace Carmichael, *Foreign Sales Corporations – Sales, Subsidies, and Trade Wars*, 35 VAND. J. TRANSNAT’L L. 151, 151 (2002).

⁶ See Report of the Appellate Body, *Brazil—Export Financing Programme for Aircraft*, Aug. 2, 1999, WT/DS46/AB/R; Report of the Panel, *Canada—Export Credits and Loan Guarantees for Regional Aircraft*, Jan. 28, 2005, WT/DS222/R; Report of the Appellate Body, *United States—Subsidies on Upland Cotton*, Mar. 3, 2005, WT/DS267/AB/R.

⁷ Several of the measures commonly used by export processing zones are on the illustrative list of export subsidies in Annex I of the SCM Agreement. They include relief from taxes and direct welfare charges, provision of goods and services on more favorable terms than goods produced for domestic consumption, government mandated favorable charges for transportation, and subsidized export credit guarantees and insurance. For a review, see Phillip English and Luc De Wulf, “Export Development Policies and Institutions,” in *DEVELOPMENT, TRADE AND THE WTO: A HANDBOOK* (Bernard Hoekman, et al., eds.) (2002). See also Dani Rodrik, “Taking Trade Policy Seriously: Export Subsidization as a Case Study in Policy Effectiveness,” in ALAN DEARDORF ET AL., EDS., *NEW DIRECTIONS IN TRADE THEORY* (1995); Edward M. Graham, “Do Export Processing Zones Attract FDI and Its Benefits: The Experience from China,” in *INTERNATIONAL ECONOMICS AND ECONOMIC POLICY* (2004).

⁸ The WTO members that received extensions of the transition period in respect of one or more export subsidy programs under SCM Article 27.4 are Antigua & Barbuda, Barbados, Belize, Colombia, Costa Rica, Dominica, Dominican Republic, El Salvador, Fiji, Grenada, Guatemala, Jamaica, Jordan, Mauritius, Panama, Papua New Guinea, St. Kitts & Nevis, St. Lucia, St. Vincent & Grenadines, Thailand and Uruguay. Not all these extensions were pursuant to the Doha decision. The actual decisions, which were taken on a program-by-program basis, may be found in WTO documents G/SCM/50 through G/SCM/102.

retaliatory awards, means that even in cases where they are *de minimis* and without harm, such subsidies could legally incur substantial retaliation.

On the other hand, many developing countries have also attacked export subsidies, particularly in agriculture. Brazil has already used the dispute settlement system to press for the abolishment of American cotton subsidies.⁹ At the Cancún Ministerial, Brazil, China, and India joined with the rest of the Group of Twenty to press for the elimination of agricultural export subsidies by a specific date. While antagonism to these export subsidies makes sense for net exporters of farm products, such as the Cairns Group, many of the poorest countries in Africa and the Middle East are net food importers and would likely suffer if export subsidies—and food aid—were reduced.¹⁰

The second reason for closely analyzing export subsidies is the implications for institutional design. In the Doha Round and beyond, the central question is what comes next. As tariff rates continue to flatten, non-tariff barriers to trade become more important to negotiation and enforcement. The institution of the WTO will need to be increasingly tooled to accommodate measures that involve adherence to rules (such as the prohibitions on export subsidies) rather than tariffs.¹¹ As the WTO grapples with more non-tariff barriers, the usual mechanism of enforcement becomes more problematic. Valuation of retaliation-rebalancing will become more difficult,¹² and legalization will need to answer to politics more as domestic policy choices are called into question.¹³ The experience with export subsidies offers a valuable study as to the problems that are likely to become more prominent as the focus shifts even more to rules whose effects are not easily quantified.

In this paper, we take up the distinctive treatment export subsidies are given in the WTO, focusing on the implications for developing countries and the larger WTO framework. We will

⁹ See, e.g., Ray A. Goldberg, Robert Lawrence, and Katie Milligan, “Brazil’s WTO Cotton Case: Negotiation Through Litigation,” *Harvard Business School Case*, No. N9-905-405 (2004).

¹⁰ There is evidence that, as a group, developing countries would face a net loss if domestic farm support in developed countries was reduced. See Bernard Hoekman, Francis Ng, and Marcelo Olarreago, “Reducing Agricultural Tariffs versus Domestic Support: What’s More Important for Developing Countries?” *Policy Research Working Paper*, No. 2918 (March 2003).

¹¹ The thorny problems of fitting non-tariff aspects of the WTO into the DSU can already be seen in “cross-retaliation” debates. See, e.g., “Brazil Asks for Cross-Retaliation under TRIPS, GATS in Cotton Dispute with U.S.,” *Bridges Weekly Trade Digest*, Oct. 12, 2005, available at <http://www.ictsd.org/weekly/05-10-12/story3.htm>.

¹² See Jackson 2004, *supra* note 2, at 121-22.

¹³ Cf. Joost Pauwelyn, “The Sutherland Report: A Missed Opportunity for Genuine Debate on Trade, Globalization, and Reforming the WTO,” 8 *J. Int’l Econ. L.* 329, 337-349 (2005) (discussing the need to avoid the legal displacement of politics).

explore the reasons for banning exports subsidies, critique the rationales for the unique retaliatory procedures, and offer some suggestions for reform. We first review the history of export subsidies in the international trading regime. Next, we establish the distinctive legal logic underlying the WTO treatment. We then ask whether these approaches make sense from an economic standpoint. Finally, we discuss policy implications and the broader impact of the export subsidies model on the WTO.

We will argue that while there are some arguments justifying a ban on export subsidies, the case is too weak to justify the SCM's per se outlawing of these subsidies and the absence of provisions for special and differential treatment for developing countries. We will point out that, if anything, economic theory suggests greater leniency, rather than stringency, is the appropriate response to violations. We will also argue that the emerging case history of retaliation awards highlights the danger of an institutional design which does not link retaliation with the damage caused by a violation, or even subject such authorizations to appellate scrutiny.

These conclusions lead us to suggest several policy reforms that would make the responses to export subsidy violations similar to those to other infractions: (a) standing to bring cases should require that the subsidies have actually had detrimental consequences to the complainant, such as nullification or impairment; (b) retaliation should be equivalent to the damage caused by the violation and authorized at the panel stage; and (c) the subsidized exports of developing countries should be given *de minimis* exemptions.

Before proceeding, two preliminary notes are in order. First, export subsidies fall within a larger category of prohibited subsidies in the SCM that also includes "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods." Such import substitution schemas are not the primary subject of this paper, although we will make some passing references to them and believe that their distinctive treatment in disputes is equally inappropriate.

Second, the Agreement on Agriculture encompasses most farm export subsidies, and it predominates over the SCM in their treatment in disputes.¹⁴ Since the push is for such export subsidies to be assessed in line with those for all other goods, we do not consider their present treatment. Instead, we are interested in how the SCM mechanism might impact future treatment.

¹⁴ See generally Richard H. Steinberg and Timothy E. Josling, "When the Peace Ends: The Vulnerability of EC and US Agricultural Subsidies to WTO Legal Challenge," 6 J. INT'L ECON. L. 369 (2003).

Therefore, we only examine the current treatment in the Agreement on Agriculture cursorily.

I. The History and Treatment of Export Subsidies

It is accepted that subsidies can serve a variety of valid policy goals. While tariffs are only rarely invoked as a first-best solution by economists, the best domestic commercial policies are often driven by careful subsidization.¹⁵ However, subsidies can also subvert market access commitments both in appearance (e.g. the “fair trade” arguments to which politicians are susceptible) and reality (e.g. a tariff reduction can be worthless if replaced with the appropriate domestic subsidy). Thus, the treatment of subsidies in the world trading system has been marked by the struggle to differentiate permissible subsidies from impermissible ones.

Export subsidies, however, have been stigmatized almost from the inception of the GATT.¹⁶ Article XVI, a single paragraph in 1947, provided only a reporting requirement for subsidies affecting trade. But as noted by John Jackson, during the 1954-55 review session, amendments were introduced—eventually, paragraphs 2 through 5 of Article XVI—that established specific rules for two broad categories of export subsidies.¹⁷ First, subsidizing the export of “primary products”¹⁸ was permissible, but only within a Contracting Party’s “equitable share of world export trade.” Second, all other export subsidies (for non-primary products) were effectively prohibited; Contracting Parties were obliged to refrain from subsidies that resulted in a price for exportation that was below the price for domestic consumption. This second category was elaborated by an illustrative list of subsidies drawn up by a 1960 GATT working party and adopted by the membership.

This approach to export subsidies was controversial. It took until 1962 before a declaration applying the second provision (now paragraph 4 of Article XVI) was open for signature. As Jackson comments, partly because of the differentiation of treatment between primary and non-primary goods, many developing countries felt that the amendment was discriminating against their trade. Consequently, not all countries were prepared to adopt the implementing declaration—in the end, only 17 developed countries accepted it.

¹⁵ The classic statement is Jagdish Bhagwati, “The Generalized Theory of Distortions and Welfare,” in *WORTH SERIES IN OUTSTANDING CONTRIBUTIONS: INTERNATIONAL ECONOMICS* (Edward Leamer, ed.) 96-111 (2000).

¹⁶ An excellent, succinct discussion of the history of subsidies in the GATT/WTO is in Alan O. Sykes, “The Economics of WTO Rules on Subsidies and Countervailing Measures,” *Chicago Law & Economics Working Paper*, No. 186, 12-17 (2003).

¹⁷ JOHN JACKSON, *THE WORLD TRADING SYSTEM* (1992) PAGE 256.

¹⁸ That is, “any product of farm, forest or fishery, or any mineral, in its natural form or which has undergone such processing as is customarily required to prepare it for marketing in substantial volume in international trade.” GATT Ad Art. XVI.

Both this reticence and the bifurcated structure carried over to the Tokyo Round Subsidies Code. For the 23 parties to that instrument, export subsidies for goods other than primary products were prohibited outright. The problematic “equitable share” provision for some primary products was detailed. However, other subsidies to domestic producers remained largely non-actionable (excepting countervailing duties), even under the Subsidies Code. Thus, by the Uruguay Round, export subsidies had acquired a unique treatment amongst trade barriers.

Based upon an early Swiss proposal in the Uruguay Round, the modern SCM takes a comprehensive, “traffic light” approach to subsidies.¹⁹ Subsidies are classified by defining prohibited subsidies (the so-called red light subsidies, export subsidies and import substitution schemes) and a limited list of non-actionable (or green light) subsidies.²⁰ All other subsidies are dumped in a middle category of actionable (or yellow light) subsidies.

For actionable subsidies, some quantum of adverse effect is required to seek a remedy. The adverse effect can be nullification or impairment of concessions, injury to domestic industry, or “serious prejudice” to a Member’s interests. Before the founding of the WTO, a Contracting Party could only act on the first ground—the traditional basis for complaint in the GATT. While countervailing, domestic injury was not grounds for dispute, and the third ground, “serious prejudice,” triggered only discussions under the GATT. The SCM, codifying multiple bases for action, also needed to provide appropriate remedies. The DSU’s ultimate enforcement mechanism—suspension of equivalent concessions—adequately responded only to nullification or impairment. Actionable subsidies thus demanded a broader mechanism: “countermeasures commensurate with the nature and degree of the adverse effects determined to exist.”²¹

For prohibited subsidies, any Member can bring a complaint, regardless of whether it is adversely affecting the member’s interests. Again, the usual DSU mechanism is inadequate: how to assign equivalent suspension when the complainant may be entirely unscathed by the subsidy in question? The last resort for a red-light subsidy, then, is the authorization of

¹⁹ The original proposal is detailed in the Communication from Switzerland, MTN.GNG/NG10/W/17 (1 February 1988)[hereinafter Swiss Proposal]. See generally EDWIN VERMULST & FOLKERT GRAAFSMA, WTO DISPUTES: ANTI-DUMPING, SUBSIDIES, AND SAFEGUARDS 281-455 (2002); ROBERT O’BRIEN, SUBSIDY REGULATION AND STATE TRANSFORMATION IN NORTH AMERICA, THE GATT, AND THE EU 102-125 (1997); GARY CLYDE HUFBAUER & JOANNA SHELTON ERB, SUBSIDIES IN INTERNATIONAL TRADE (1984). Note that the rights and remedies contained in the SCM trump conflicting provisions in the DSU. SCM, *supra* note 4, art. 1.2.

²⁰ Green light subsidies focused on research and development. Per Article 31 of the SCM, *supra* note 4, the provisions on green-light subsidies—introduced temporarily—expired in 2000; they have yet to be revived.

²¹ SCM, *supra* note 4, arts. 7.9 & 7.10.

“appropriate countermeasures.” The word “appropriate”²² is qualified by a notorious and puzzling footnote, “This expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited.” The unique treatment of export subsidies endures.

The Agreement on Agriculture is an important carve-out from the SCM. Alan Sykes has noted that the approach to agriculture subsidies is not unlike the gradual reduction of tariffs that is the mainstay of GATT.²³ Both the red- and yellow-light portions of the SCM specifically exempt subsidies covered by the Agriculture Agreement. The latitude accorded the primary products of old has largely shifted to the Agriculture Agreement, and even export subsidies are accommodated within certain ceilings. Compared to the conventional treatment of export subsidies, this measured lowering of barriers can only be attributed to the hostility of developed countries to wholesale agricultural liberalization.

²² The term “appropriate” is loaded with meaning, which is addressed to some degree later in the paper. In the context of current and past agreements, it is interesting to note that the original GATT Agreement’s paltry dispute settlement mechanism, Article XXIII, provided for retaliation “appropriate to the circumstances.” Unfortunately, what constituted “appropriate” was addressed only once in the pre-WTO era, when the Netherlands was authorized to retaliate against the United States. Netherlands Measure of Suspension of Obligations to the United States, Nov. 8, 1952, GATT B.I.S.D. (1st Supp.) at 32 (1953). Rather strangely, “appropriate,” sans footnote, qualifies “countermeasures” in the remedy for green-light subsidies, but not the remedy for amber-light subsidies. Compare SCM, *supra* note 4, arts. 7.10 & 9.4.

²³ Sykes, *supra* note 16.

II. The Legal Logic of Export Subsidies

The modern treatment of subsidies in WTO thus bears out a distinctive legal logic for non-agricultural export subsidies, the so-called red light subsidies. First, they are illegal—period. There is no need to show the nullification or impairment of benefits, no need to demonstrate harm to a domestic industry. Second, and closely tied to the first, any Member may complain about an export subsidy. The aggrieved party need not be the one most affected by the subsidy – conceivably, the Member need not be affected at all. Third, rather than traditional WTO remedies, a complainant may seek “appropriate countermeasures.” A rebalancing of concessions based upon trade effects—the ordinary metric under the DSU—doesn’t necessarily make sense when an export subsidy may not have any trade effects vis-à-vis the complaining Member.

These distinctions can be observed simply by reading the text of the WTO Agreements. Much of the SCM text on export subsidies can’t be found anywhere else in the 17,000 or so pages of the Uruguay Round documents. Since one of the canons of legal interpretation is to imbue these differences with meaning, it is no surprise that Panels and arbitrators have taken a different tack when dealing with export subsidies.

In our view, this shield of textual orthodoxy foretells a potentially dangerous drift in the theoretical underpinnings that have made the GATT/WTO regime so successful. To fully explore this shift, we investigate the legal theories that might support the SCM text and its interpretation. We conclude that the treatment of export subsidies reflects a theoretical and practical orientation inconsistent with the rebalancing of rights and obligations in the WTO.

A. Per Se Illegality

Throughout the Uruguay Round, negotiators emphasized that export subsidies should be prohibited per se, in keeping with the steps of the Tokyo Round Subsidies Code. Such a categorical rule is rare in the WTO, with most obligations being part of an exchange of “concessions”—the lodestar being the inexorable decline of average tariff rates. However, even in the early GATT, prohibitions were used to great effect, most famously in the elimination of quantitative restrictions.²⁴

²⁴ GATT Article XI.

Prohibition became even more common with the Uruguay Round Agreements. For example, export performance requirements are prohibited in the Agreement on Trade-Related Aspects of Investment Measures (TRIMS), as is conferring benefits to foreign companies that use domestic inputs.²⁵ The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) prohibits Members from allowing trademarks or patents from being used in an array of ways.²⁶ Smaller prohibitions abound. The Antidumping and Safeguards Agreements contains a bevy of injunctions as to how investigations for trade remedies should be conducted.²⁷

Indeed, the “legalization” of the WTO and the move to a rules-based system has been exhaustively documented.²⁸ Rules can define what is permissible, but they tend more often to define what is impermissible. While the prohibition of export subsidies may be worded incisively, it alone is not enough to distinguish their treatment in the WTO. Rather, one must examine prohibition in conjunction with the peculiar rules of legal standing and remedies accorded those Members complaining of another’s export subsidy.

B. Standing without Actual or Potential Injury

Standing is simply the legal right to bring an action, to seek redress. In the WTO framework, that right is generally based on a crude notion of injury.²⁹ A complainant alleges nullification or impairment of benefits under GATT Articles XXII and XXIII, and then seeks enforcement through the procedures of the DSU. If the allegation is born out by a Panel and the Appellate Body, and the scofflaw does not withdraw the offending measure, the complainant is authorized

²⁵ Agreement on Trade-Related Aspects of Investment Measures, *in* WORLD TRADE ORGANIZATION, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS art. 2 (1999) [hereinafter TRIMS Agreement].

²⁶ Agreement on Trade-Related Aspects of Intellectual Property Rights, *in* WORLD TRADE ORGANIZATION, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS (1999) [hereinafter TRIPS Agreement].

²⁷ Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 & Agreement on Safeguards, *in* WORLD TRADE ORGANIZATION, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS (1999) [hereinafter Antidumping Agreement & Safeguards Agreement].

²⁸ For example, the millennial issue of *International Organization* intermittently uses the WTO as a case study for “legalization” in international relations. *See, e.g.*, Robert O. Keohane, Andrew Moravcsik, and Anne-Marie Slaughter, “Legalized Dispute Resolution: Interstate and Transnational,” 54 INT’L ORG. (2000).

²⁹ “Injury” is an imprecise term. In the rubric of trade negotiations, politically painful “concessions” are made by the Member States to liberalize trade. Theoretically, injury is also a much broader concept than nullification and impairment. We use “injury” as shorthand to refer to adverse effect on current or future trade, a traditional metric in the WTO.

to retaliate by revoking trade concessions “equivalent to the level of the nullification or impairment.”³⁰

This process, together with the initial allegation of nullification or impairment, is pervasive. Virtually every part of the WTO Agreements adheres to the original dispute settlement articles of the GATT, as elaborated by the DSU.³¹ A complaint is initiated when a Member “considers” that its benefits are being impaired. Two questions are raised. First, what is the content of the asserted “injury”—the nullification or impairment—required for standing? Second, can one Member complain on behalf of another or the collective Membership?

As to what “injury” must be asserted, the Dispute Settlement Body (DSB) has treated standing in WTO disputes loosely. Some commentators, such as Petros Mavroidis,³² have pointed to the language in *EC—Bananas*, in which the Appellate Body noted that adverse trade effects were not necessary for standing.³³ In that case, the United States had yet to export any bananas to the EC; indeed, it hardly produced any. The Appellate Body statement permitted the United States to bring a case even though it could demonstrate no actual trade diversion—only potential. The Appellate Body interpretation is consistent with the peculiar language of “nullification or impairment.” The usual dispute settlement process does not invoke “injury” or “damages” because it is recognized that the value of concessions may be reduced without *de facto* adverse trade effects.

Were this the end of it, confusion would be minimal. However, the Appellate Body also emphasized the broad discretion accorded WTO Members in whether or not to bring a case and

³⁰ DSU, *supra* note 2, art. 22.4.

³¹ See Safeguards Agreement, *supra* note 27, art. 14 (applying “provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding”); TRIPS Agreement, *supra* note 26, art. 64 (the same); Antidumping Agreement, *supra* note 27, art. 17 (retaining the nullification and impairment threshold); General Agreement on Trade in Services, art. XXIII (hewing to the same). See also Agreement on Technical Barriers to Trade, art. 14, annex 2; Agreement on the Application of Sanitary and Phytosanitary Measures, art. 10; Agreement on Implementation of Article VII of GATT 1994 (Customs Valuation), art. 19, annex 2 (applying GATT/DSU standards *mutatis mutandis*, albeit with the aid of experts where necessary), all in WORLD TRADE ORGANIZATION, THE LEGAL TEXTS: THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS (1999).

³² Petros C. Mavroidis, “Remedies in the WTO Legal System: Between a Rock and a Hard Place,” 11 *Eur. J. Int’l L.* 763 (2000).

³³ The Appellate Body said that a claimant needed no “legal interest” to bring a claim under the DSU, although it must have meant no adverse trade effect since a state must surely have an interest in seeing the law obeyed. Report of the Appellate Body, *E.C.—Regime for the Importation, Sale, and Distribution of Bananas*, Sept. 25, 1997, WT/DS27/AB/R, ¶¶132-33 [hereinafter *EC—Bananas*]. For a brief but illuminating discussion of this distinction, see Joost Pauwelyn, “A Typology of Multilateral Treaty Obligations: Are WTO Obligations Bilateral or Collective in Nature?” 14 *EUR. J. IN’TL L.* 907, 941-42 (2003).

how the “increasing interdependence of the global economy” had made it more likely that a breach of WTO obligations would affect a Member.³⁴ One possible implication is that a Member could bring a complaint on behalf of another Member, or even the collective Membership, since WTO obligations—and their breach—can affect many.

But as Joost Pauwelyn notes, nothing in the Appellate Body ruling implies that *only* a legal interest—that is, every Member’s interest in seeing WTO rules complied with—is sufficient for standing.³⁵ In fact, the Appellate Body tied the standing of the United States to a number of material reasons, and indicated that a subset of factors would not necessarily be sufficient for a claim. If a mere legal interest is insufficient for standing, it then follows that one Member would not be able to assert a complaint on behalf of another or the collective Members.

In our view, Pauwelyn’s reading of *EC—Bananas* is the best interpretation of the usual grounds for standing in the WTO specified by the Appellate Body. He adduces two requirements.³⁶ First, “the inconsistent measure must at least *apply to the trade of that member*, albeit potential trade only.” Second, “even if the measure does apply *de jure* to trade from that other member, some proof must be shown that either actual or potential trade flows may be restricted and/or that the member is otherwise economically affected.” This interpretation accords with GATT Article XXIII, still the first principle of WTO dispute settlement. The baseline for initiating proceedings per that Article is that a Member “consider that any *benefit accruing to it* directly or indirectly ... is being nullified or impaired ...” (emphasis added). The DSU reflects the same.³⁷

For standing in the vast majority of WTO disputes, then, Members must allege an injury—actual or potential—done to them. For the most part, this is the way that standing can be understood in disputes under the SCM, though the nature of injury is further specified. To contest an actionable, yellow-light subsidy, a Member must have reason to believe that the subsidy is injuring one of its domestic industries, nullifying or impairing a concession, or causing serious prejudice to its interests.³⁸ While there are two additional bases for alleging injury, essential standing remains predicated on Pauwelyn’s two-part interpretation.

³⁴ *EC—Bananas*, *supra* note 33, ¶¶135-36.

³⁵ Pauwelyn, *supra* note 33, at 941-45.

³⁶ *Id.*

³⁷ DSU, *supra* note 2, art. 3.3.

³⁸ SCM, *supra* note 4, art. 7.1.

There are no such requirements for challenging an export subsidy. Alone among WTO obligations, standing is essentially universal. Under Article 4.1 of the SCM, a Member needs only “reason to believe that a prohibited subsidy is being granted or maintained by another Member” Any WTO Member can challenge any export subsidy for any reason.

Broadly, two legal theories can justify such a principle. The first is that the obligation to refrain from export subsidies is a collective one, owed to the community of WTO Members—an obligation *erga omnes partes*. This interpretation is not a familiar one in trade law,³⁹ but it is commonplace in other international instruments.⁴⁰ Such a theory underlies most human rights treaties, for example.

The implication of a collective obligation is that any Member has standing, on the part of all Members, to complain about a breach. An imprecise municipal analogy is criminal statutes, where the state is granted standing on behalf of all citizens to try a citizen for, say, murder. In international law, where there is no sovereign, one state acts on behalf of the community to enforce the obligation—a form of *actio popularis*. This approach appears to underlie the controversial arbitration in *US—Tax Treatment*, which is worth quoting at length:

[T]he United States’ breach of obligation [by the FSC subsidy] is not objectively dismissed because some of the products benefiting from the subsidy are, e.g., exported to another trading partner. It is an *erga omnes* obligation owed in its entirety to each and every Member. It cannot be considered to be “allocatable” across the Membership. Otherwise, the Member concerned would be only partially obliged in respect of each and every Member, which is manifestly inconsistent with an *erga omnes per se* obligation. Thus, the United States has breached its obligation to the European Communities in respect of all the money that it has expended, because such expenditure in breach—the expense incurred—is the very essence of the wrongful act.⁴¹

³⁹ An exhaustive, topographical analysis of WTO obligations as collective or bilateral is Pauwelyn, *supra* note 33. He concludes that they are bilateral, despite collective features in more recent agreements—such as the nature of standing for prohibited subsidies under the SCM.

⁴⁰ The literature is vast. See, e.g., M. Cherif Bassiouni, “International Crimes and Obligations Erga Omnes,” 59 LAW & CONTEMP. PROBS. 63 (1996); INTERNATIONAL LAW COMMISSION, ARTICLES OF STATE RESPONSIBILITY, arts. 42, 48, and accompanying commentary.

⁴¹ Decision of the Arbitrators, *US—Tax Treatment for “Foreign Sales Corporations,”* Aug. 30, 2002, WTO Doc. WT/DS108/ARB ¶6.10 [hereinafter *Tax Treatment Arbitration*]. The United States was a major supporter of the need for a separate agreement for disputes in the case of prohibited export subsidies. This suggests that the U.S. felt the likelihood that it could fall foul of this provision was small. It is ironic therefore that it now finds itself subject to retaliation that is far larger than would have occurred under the DSU rules.

One can read the Arbitrator's logic back to the point of standing, at the outset of the dispute. Export subsidies are per se illegal, and the obligation to refrain from them is a collective one owed to each and every WTO Member. Therefore, any WTO Member may bring a claim on behalf of the collective. If that claim is successful, and the offending measure is not withdrawn, then the complaining Member is entitled to impose countermeasures to the full amount of the subsidy since it is acting on behalf of the Membership. The arbitrators' decisions follow naturally from a legal theory that also justifies universal standing.

The second way to theorize such broad-swept standing is to follow Pauwelyn's interpretation, and to consider the obligation to refrain from export subsidies as a bundle of bilateral obligations. In other words, each Member owes every other Member the obligation. How might that justify universal standing? Because such subsidies affect all of a country's exports, they conceivably affect, or have the *potential* to affect, at least some of the trade of all other countries. Investment in a subsidized sector will be dampened worldwide. Standing is therefore not a consequence of some "special" SCM obligation, but merely the logical conclusion of ordinary WTO standing requirements applied to export subsidies. As the Swiss Proposal noted at the outset of SCM negotiations, it is cumbersome and unfair to require a specific allegation of nullification or impairment when export subsidies are deemed per se illegal because of their effects on world trade.⁴²

However, this interpretation is unsatisfying. One must distinguish between general export subsidies (like the American FSC arrangement) and narrow or industry-specific ones (like export subsidies given directly to Airbus or Boeing). The former can dampen world trade without regard to product or country, since it could be applied to most any market given the necessary conditions. The second category of subsidies, however, makes the case for potential trade loss more tenuous. For example, if the United States gives Boeing (or its aircraft industry) an illegal export subsidy, the theory would justify a Mauritian claim that its potential aircraft exports would be affected.

Some limit must be drawn to eliminate the unreasonable claims; otherwise, specious litigation is encouraged and limited WTO resources taxed. Hence the second of Pauwelyn's prudential requirements: *de jure* effect is insufficient, and some proof must be shown. This

⁴² Swiss Proposal, *supra* note 19.

concern also underlies the Appellate Body's concern in *EC—Bananas* for the collective evidence of potential effect.⁴³

Such prudential limits are absent for export subsidies. Recall that the language of the SCM requires only that a complaining Member have “reason to believe” that an export subsidy is being maintained. There is no latitude for accepting claims against general export subsidies while rejecting tenuous claims made against specific export subsidies. Unlike claims for the potential trade effects of a tariff or quota, all claims against export subsidies must be heard—no matter how remote the impact on the claimant might be.

In our view, then, the current approach to standing embodied in the SCM allows for no actual or potential injury requirement, either on prudential grounds or otherwise. Regardless of whether the export subsidy obligation is collective or bilateral, standing is unconnected to actual or potential injury. Unless one considers the obligation to refrain from export subsidies an obligation *erga omnes*, then the theory underlying universal standing is quite thin indeed, especially when considered from the traditional GATT/WTO perspective. Without the usual nod to injury, the approach of negotiators and arbitrators (excepting *U.S.—Tax Treatment*, which apparently adopted the *erga omnes* conception) appears to be blunt: these subsidies are illegal, therefore it is only proper that anyone can challenge them. How else to justify standing predicated only on the “reason to believe” that a subsidy is being maintained?

The theory of standing, in turn, directly impacts what one makes of “appropriate countermeasures.” Standing mediates between the illegality of export subsidies and countermeasures. Without an injury requirement, the phrase can be loaded with arbitrary meaning. As we will see, arbitrators have imposed such high levels of retaliation in part because of the illegality or stigma of export subsidies. But if standing were rooted in actual or potential trade effects, it would follow that retaliation be based on those effects, albeit with some latitude for problems of calculation. Without injury, the metric of “appropriateness” must be something else—such as the *per se* illegality of the act.

C. “Appropriate Countermeasures”

⁴³ *EC—Bananas*, *supra* note 33, ¶138 (“[O]ne or more of the factors ... would [not] necessarily be dispositive in another case.”).

Standing is not the only peculiar treatment of export subsidies in the WTO; the rules relating to retaliation in the face of violations are also different. Article 22(4) of the DSU states, “The level of suspension of concessions . . . shall be equivalent to the level of the nullification and impairment.” In most cases, this is interpreted to mean that plaintiffs can only take measures that reflect the amount of trade they have lost by the violation.⁴⁴

However, the SCM provisions relating to export subsidies use different language. Article 4.10 of the SCM allows Members to take “appropriate countermeasures” in response to export subsidies. They are also supposed to be proportionate, but this language is clearly different from “equivalent” in the DSU. What is to be understood by the term “appropriate”? In what sense should the countermeasures be proportionate? Proportionate to the dollar value of the subsidy? Proportionate to the impact of the subsidy on trade? Or proportionate to the gravity of the transgression? Given the very different preconceptions that are held about the WTO system, in particular the contrasting perspectives of those who view WTO violations like contract breaches and those who regard them as violations of obligations to the community, this wording seems designed to cause trouble—and it has.⁴⁵

In fact, the problems might have been anticipated because the original GATT contained a similar ambiguity. In response to violations, GATT Article XXIII (Nullification or Impairment) allows such suspensions of concessions as the Contracting Parties “determine to be appropriate in the circumstances.” By contrast, Article XXVIII (Rescheduling of Concessions) spoke of providing “substantially equivalent concessions” in response to tariff rescheduling. These differences in wording led the Legal Adviser to the Director General of the GATT to argue that in responses under Article XXIII “other factors could be taken into account.” Implicitly, therefore, the response could be *greater* than equivalent to the amount of trade subject to nullification and impairment by the violation.⁴⁶ The Uruguay Round Agreement eliminated this discrepancy and made it clear in the DSU that retaliation can be no larger than the nullification and impairment resulting from the violation.⁴⁷ But when it came to the SCM agreement, the

⁴⁴ This conclusion, determined by DSU language, holds whether or not one believes the *purpose* of retaliation is to induce compliance or merely rebalance concessions. See discussion *supra* note 3.

⁴⁵ The vague language has invited commentators, arbitrators, and Members to import their own meaning, predicated on their biases about the purpose of retaliation. For an overview of these views, see LAWRENCE, *supra* note 3.

⁴⁶ For a more complete discussion, see ANALYTICAL INDEX OF THE GATT 696-700.

⁴⁷ According to Weiss, “[The International Trade Organization Charter originally made] clear that retaliation was not to exceed the amount needed for the harm done.” He observes, “The DSU text thus returns to the final intentions of the GATT/ITO negotiators.” IMPROVING WTO DISPUTE SETTLEMENT PROCEDURES (Friedl Weiss & Jochem Wiers,

Uruguay Round opened another Pandora’s Box, evident in scholarly writings and the findings of the three WTO Arbitrations that have granted permission to retaliate over export subsidies: a Canadian challenge of Brazilian subsidies for aircraft exports (*Brazil—Aircraft*),⁴⁸ a European challenge of the United States FSC tax provisions (*US—Tax Treatment*),⁴⁹ and a Brazilian challenge of Canadian aircraft export subsidies (*Canada—Aircraft II*).⁵⁰

“Countermeasures” have a storied history in international law, but the term’s location in the SCM stands alone in the WTO Agreements. “Appropriate countermeasures” against illegal subsidies made their first appearance in Article 18(9) of the Tokyo Round Subsidies Code. If a recommendation to rectify a subsidy was not followed, the provision allowed “appropriate countermeasures (including withdrawal of GATT concessions or obligations) taking into account the nature and degree of the adverse effect found to exist.” In the Swiss Proposal, appropriate countermeasures were considered the natural response to the breach of a per se obligation. Coming from a traditional position of international law, the Proposal noted that unilateral, proportional countermeasures were the legal answer to a breach. Evidently, language sourced in this notion survived the negotiating process.

But why treat export subsidies differently from any other obligation when it comes to retaliation? The first thought is that “appropriate countermeasures” are only fitting to induce compliance with an action deemed illegal per se. Apparently, this perspective informed the original Swiss proposal, which deemed a nullification or impairment requirement “hardly consistent” with prohibition.⁵¹ Unlike a safeguard action or dumping order, export subsidies are per se outlawed. This line leaves little latitude for Members to plausibly argue that they had a reasonable alternative interpretation of the law, or even just made a mistake. Therefore, something “more” is attached to noncompliance—perhaps a dose of blameworthiness, of fault.⁵²

eds., 2000) 389 n.35. The arbitrators in the case of EC—Bananas emphasize that the equivalence standard required by DSU art. 22.7 is stricter than under GATT. Arbitration Decision, EC—Regime for the Importation, Sale, and Distribution of Bananas, Apr. 9, 1999, WTO Doc. WT/DS27/ARB ¶¶6.3-6.5 [hereinafter Bananas Arbitration].

⁴⁸ Decision of the Arbitrators, *Brazil—Export Financing Programme for Aircraft*, Aug. 28, 2000, WT/DS46/ARB [hereinafter Brazil Aircraft Arbitration].

⁴⁹ Tax Treatment Arbitration, *supra* note 41.

⁵⁰ Decision of the Arbitrators, *Canada—Export Credits and Loan Guarantees for Regional Aircraft*, Feb. 17, 2003, WT/DS222/ARB [hereinafter Canada Aircraft Arbitration].

⁵¹ Swiss Proposal, *supra* note 19, at ¶2.1.

⁵² While we do not pursue it further, fault is a notoriously difficult issue in international law, not the least because the object of enforcement is a state and not an individual.

An export subsidy is tantamount to an *intentional* breach of the WTO Agreements and deserving of special enforcement.

This approach is bolstered by the injunction in SCM Article 4.7 to withdraw export subsidies “without delay.” While arbitrators dating back to *EC—Bananas* have claimed the purpose of retaliation is to induce compliance,⁵³ those dealing with export subsidies have imbued the SCM with a much more potent variant of that objective. The arbitrators in *Brazil—Aircraft* defined a countermeasure as appropriate “inter alia if it *effectively* induces compliance.”⁵⁴

A second possible reason for different treatment returns to the theory of an obligation *erga omnes partes*. If the obligation to refrain from export subsidies is owed to every WTO Member, then traditional retaliation is insufficient. Ordinary retaliation—equivalent suspension—only deals with the breach vis-à-vis the complaining party. If the obligation is truly *erga omnes partes*, then the complaining party is acting on behalf of the Membership and needs to be accorded countermeasures to fulfill that role.

The final approach is that equivalence is simply harder to attain in retaliating against export subsidies. While the economic impact of subsidies on trade is well-documented, the already-difficult process of calculating trade effects is compounded by a process centered on outflows as opposed to inflows. The process is further complicated by the daunting task of assigning *which* countries are affected by the subsidy.⁵⁵ And the entire dispute may be more about potential impact than actual impact—the calculus of contingency is never easy.

These theories and beliefs about the underlying purpose of WTO remedies inform one’s answer to the real question: what are “appropriate countermeasures”? In the arbitrations to date, the answer seems to be the dollar amount of the subsidy, sometimes with a categorical premium to further induce compliance. Any notion of trade effects, future lost trade, compensation, commensuration, or other reference to the amount of actual or potential injury is absent. This result is predicted by the first theory—an export subsidy is an illegal act which must at all costs be complied with—and to some extent the second. Only the third theory—that “appropriate countermeasures” is designed to capture the vagaries of equivalence vis-à-vis export subsidies—

⁵³ *Bananas Arbitration*, *supra* note 47, ¶6.3. See also DSU, *supra* note 2, art. 3.7 (“[T]he first objective of the dispute settlement mechanism is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of any of the covered agreements.”).

⁵⁴ *Brazil Aircraft Arbitration*, *supra* note 48, ¶3.44.

⁵⁵ *Cf.* Tax Treatment Arbitration, *Submission of the United States* (arguing that since the impact of a subsidy was difficult to determine, a pro-rated share of world trade was an appropriate proxy).

gets short shrift. If it was underlying the arbitrations, one would predict retaliation based at least partially on actual or potential injury.

Let us unpack this conclusion by looking to the arbitrations themselves. Article 4.10 of the SCM, in which the term “appropriate countermeasures” appears, has a footnote appended to “appropriate” by which one might have hoped to clarify matters. But it has served only to increase confusion. The footnote reads, “This expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under the provisions are prohibited.”⁵⁶ The first reaction of most people who read this footnote is “huh?” It is as clear as mud. The trouble comes from the murky relationship between the first and second parts of the sentence. How do the two parts work together?

The first possibility is to assume that “in light of” is simply an awkward way of saying “despite.” This interpretation would likely align responses to the SCM with those of the DSU. Indeed, this is how legal scholar Petros Mavroidis reads it.⁵⁷ He acknowledges greater ambiguity as to the level of countermeasures against illegal subsidies. The term in the SCM is “proportionate” whereas in the DSU the term is “equivalent.” He notes that the footnote states that proportionate is “not disproportionate” and argues that the only reasonable interpretation of the term is that punitive damages are to be excluded. There could be “small deviations”—consonant with a theory that justifies differential treatment according to calculation problems—but “the benchmark must be the damages suffered.” In this interpretation, because it is more difficult to estimate the impact of subsidies on exports, some additional leeway is granted in coming up with the value of suspension to be authorized, but basically it should be commensurate with the impact on trade, similar to how actionable subsidies are treated.

A second approach is to admit that the footnote is basically unintelligible and ignore it. This is reaction of the arbitrators in *Brazil—Aircraft*. They observe, “[I]t seems difficult to identify how the second part of the sentence, in light of the fact that subsidies dealt with are prohibited, relates to the first part of the sentence.” Although they are inclined to believe that “the reference to the fact that the subsidies dealt with are prohibited can most probably be considered more as

⁵⁶ A comparison of proportionality in actionable—amber light—subsidies is unhelpful. There, according to art 7.10 of the SCM, the countermeasures should be “commensurate with the degree and nature of the adverse effects determined to exist.” It is unclear how “commensurate” is distinct from “proportional.”

⁵⁷ Mavroidis, *supra* note 3.

an aggravating factor than as a mitigating factor,” they deliberately chose not to draw any conclusions as to the meaning of the footnote.⁵⁸

It is therefore surprising that the arbitrators in *US—Tax Treatment* offer a third interpretation. To them, the meaning of the footnote is crystal clear.⁵⁹ They emphasize that a proportionate response does not require exact equivalence. They state, “[W]e receive more guidance in the final part of the footnote in the use of the term ‘in light of’ that the final part of the footnote is a matter that must enter into consideration at all times. *It is an element that is to pervade or color the whole assessment.*” (emphasis added) In other words, they claim that the purpose of the footnote is to allow responses that are relatively large and certainly not limited to the trade effects. As Joel Trachtman has perceptively pointed out to us in verbal communication, their interpretation would have been the same had the word “not” been dropped from the first part of the footnote.

On the basis of this interpretation, the arbitrators allowed one plaintiff, the European Union, to suspend concessions equal to the full value of the FSC subsidy—some \$4 billion. The United States had argued that retaliation should reflect Europe’s share in world trade.⁶⁰ However, the arbitrators rejected the argument that trade effects should guide the analysis. They argued, “[T]he unlawful character of the subsidy upsets the balance of rights and obligations irrespective of what might be, as a matter of fact, the actual trade effects on the complainant.” Indeed, the arbitrators make the extraordinarily strong claim that “the United States’ breach of obligation is . . . an *erga omnes* obligation owed in its entirety to each and every Member. It cannot be considered to be “allocatable” across the Membership.”⁶¹ It seems the arbitrators contemplate a scenario where each WTO Member could legally impose \$4 billion worth of countermeasures!

Notwithstanding their decision to ignore the footnote, the arbitrators in *Brazil—Aircraft* came to a similar conclusion. “Appropriate countermeasures” by Canada did not have to be confined to the loss of Canadian aircraft sales attributable to the subsidies. The arbitrators rejected

⁵⁸ Brazil Aircraft Arbitration, *supra* note 48. However, the arbitrators did note that the footnotes “at least confirm that the term appropriate in Articles 4.10 and 4.11 of the SCM should not be given the same meaning as the term equivalent in Article XXII of the DSU.”

⁵⁹ “This footnote effectively clarifies how the term appropriate is to be interpreted.” Tax Treatment Arbitration, *supra* note 41, at 11.

⁶⁰ The United States argued that estimates of the trade effect using economic models are unreliable. The U.S. was therefore prepared to use the \$4 billion cost of the FSC as a proxy for the aggregate trade impact. Since Europe accounts for just over a quarter of world trade, the impact on its trade should be placed at about a quarter of the FSC cost, or \$1 billion.

⁶¹ Tax Treatment Arbitration, *supra* note 41, ¶6.10.

Brazil's argument that retaliation in excess of Canada's trade loss would be "disproportionate." Indeed, they too rejected the idea that retaliation should be commensurate with the level of nullification or impairment. Instead they authorized Canada single-handedly to suspend concessions against Brazilian exports in an amount equal to the full value of the subsidy, worrying that countermeasures based on the actual level of nullification or impairment might offer little inducement for Brazil to withdraw the subsidies. The arbitrators explicitly viewed the purpose of countermeasures as to induce compliance.

The arbitrators in *Brazil—Aircraft* claimed, "A countermeasure becomes punitive when it is not only intended to ensure that the State in breach of its obligations bring its conduct into conformity ... but contains an additional element meant to sanction the action of the state."⁶² This interpretation is a fascinating example of a slippery slope: instead of using the value of trade lost as a basis for assessing what is punitive, it focuses on the goal of forcing compliance. Implicitly, this shifts the focus from the harm done to the complainant to the benefits of the infraction to the violator. Suppose that the United States would have to be threatened with \$10 billion in suspended concessions before it would agree to remove the \$4 billion FSC subsidy. Under the arbitrators' interpretation, an award to obliterate all such trade would not be considered punitive.⁶³

In *Canada—Aircraft II*, Brazil sought permission to take countermeasures worth \$3.36 billion. Brazil based its petition on estimates of all the contracts won by Bombardier, the Canadian aircraft company, in which the illegal subsidies had been provided, as well as the sales of services and parts that might have been expected.⁶⁴ However, the arbitrators accepted Canadian arguments that countermeasures of such magnitude would be disproportionate—particularly when compared to the other two cases of retaliation. The arbitrators therefore chose to follow their predecessors and use the amount of the subsidy as the base level of authorized retaliation—an estimated \$206 million. However, they added an additional 20 percent to reach a level of countermeasures which they thought could reasonably induce compliance, accordingly authorizing suspension of \$248 million. But why 20 percent and not 40 percent? Is this

⁶² Brazil Aircraft Arbitration, *supra* note 48. Contrary to Article 3.7 of the DSU, Article 4.7 of the SCM does not provide for any alternative than the withdrawal of the measure once it has been found to be a prohibited subsidy.

⁶³ Perhaps this dangerous slope is what the arbitrators in *U.S.—1916 Act* had in mind when they noted that "any suspension of obligations in excess of the level of nullification or impairment would be punitive." Decision of the Arbitrators, *US—Anti-Dumping Act of 1916*, Feb. 24, 2004, WT/DS136/ARB ¶5.22.

⁶⁴ Brazil only included sales after the date on which the subsidy should have been withdrawn.

arbitration or arbitrariness? With considerable understatement, the arbitrators concede that “such adjustments cannot be precisely calibrated.”⁶⁵ Indeed. While measures such as the trade effects and the value of subsidies are subject to uncertainty, they are at least somewhat objectively grounded. If arbitrators feel free to arbitrarily add premiums, it is only a matter of time before wildly different and inconsistent approaches are adopted.

This latest arbitration confirms the theory underlying the current approach to export subsidies. Why treat export subsidies differently from any other WTO obligation when it comes to retaliation? For the arbitrators, the rough logic is thus: the fact that export subsidies are per se prohibited means that “appropriate countermeasures” are whatever arbitrary level of retaliation (loosely based on the dollar amount of the subsidy) is necessary to induce compliance.⁶⁶ The arbitrators in both *Brazil—Aircraft* and *Canada—Aircraft II* were clearly operating upon the principle that export subsidies somehow demand compliance more stringently than other WTO obligations (resting the second point on the rather thin reed of “without delay”). An especially unsettling variant—exemplified in *US—Tax Treatment*—would treat the prohibition as *erga omnes partes*, and presumably authorize retaliation in the amount of the subsidy for whatever Member brought the claim (even if that Member had no trade with the violator), or even multiple retaliations for multiple complainants.⁶⁷

It is as yet unclear as to whether the expansive reading given by these arbitrators will be emulated. Rulings in individual WTO cases do not establish binding precedents. However, at a minimum, these recent cases reveal an important flaw in the dispute settlement design. The decisions of arbitrators, who are generally the original panelists involved in the case, are final and cannot be appealed. This permits the distinct possibility that cases will not be treated consistently.

D. Some Implications of the Legal Logic

⁶⁵ Canada Aircraft Arbitration, *supra* note 50.

⁶⁶ “Based on the plain meaning of the word, this means that countermeasures should be adapted to the particular case at hand. The term is consistent with an intent not to prejudge what the circumstances might be in the specific context of dispute settlement in a given case. To that extent, there is an element of flexibility, in the sense that there is thereby an eschewal of any rigid a priori quantitative formula. But it is also clear that there is, nevertheless, an objective relationship which must be absolutely respected: the countermeasures must be suitable or fitting by way of response to the case at hand.” Tax Treatment Arbitration, *supra* note 41, ¶5.12.

⁶⁷ Tax Treatment Arbitration, *supra* note 41, ¶6.28 (implying that any and all Members could bring a case).

Taking standing and countermeasures together, we are left with a simple but troubling legal logic to explain the current approach to export subsidies by both negotiators (after all, the text is at the root) and arbitrators. Export subsidies are so pernicious that any Member can challenge them, and only compliance is an acceptable response. Therefore, standing is just plain open, with no prudential injury requirement, and any Member can bring a claim seeking whatever retaliation is necessary to induce compliance.⁶⁸

We may distill three conclusions from this approach. First, since standing is unconstrained, Members can bring complaints for retaliatory, petulant, or punitive reasons. Second, it is impossible for a Member to predict future liability for an errant export subsidy. Third, Members can expect authorized retaliation substantially disproportionate to—that is to say, higher than—any (potential) injury caused by the subsidy.

It is difficult to understand the rationale for singling out export subsidies for such harsh treatment, by a legal mechanism seemingly destined to strain WTO legitimacy and power. For example, the Agreement on Agriculture deals with export subsidies—why is a breach there treated so lightly compared to a breach of the SCM? Are export subsidies covered by the SCM somehow worse? Or even consider the SCM itself. While the articles on prohibited subsidies do allow for distinctive treatment in WTO proceedings, the articles on countervailing measures treat all subsidies alike. Are export subsidies somehow more dangerous in the DSU process than in a countervailing action?⁶⁹

The distinction is important. In effect, both negotiators and arbitrators have said that compliance with the export subsidy obligation is paramount, no matter the result for the legitimacy of the WTO and the reciprocity-cum-rebalancing paradigm that has dominated the GATT since its inception. *Inducing compliance* is privileged over *rebalancing rights and*

⁶⁸ The theory seen in the Tax Treatment Arbitration, where the obligation is considered *erga omnes partes*, is particularly potent variant of this logic. The underlying principles are the same, but standing is granted not just because of the illegality of the act, but because the claimant is acting on behalf of all. Theoretically, this concept of standing is sounder, but there is little evidence that it is the dominant logic of the negotiators and arbitrators.

⁶⁹ GATT art. VI(6)(a) required finding material injury or the threat of injury to an established domestic industry (or retarded the establishment of a domestic industry) but it gave the Contracting Parties the power to waive this requirement. GATT art. VI(6)(b) stipulated that when a contracting party wished to levy a countervailing duty on a dumped or subsidized product that causes material injury to an industry in the territory of another contracting party exporting the product concerned to the territory of the importing party. Interestingly, the idea of one party retaliating on behalf of others is not new, what is new is doing this without injury or another prudential standing requirement.

obligations, effectively importing specific beliefs about the purpose of the WTO remedies into the structure itself, all with minimal politics to develop consensus.

There are two steps to understanding the impact of this change. The first is to examine the economic underpinnings of export subsidies. If export subsidies are somehow different in the economics of trade, then there is a normative justification—welfare maximization—for an appropriate special regime.⁷⁰ The second step is to ask what the implications of the export subsidy model are for the broader WTO and developing countries. Those conclusions will be quite different depending on how strong the economic case for the present regime is.

⁷⁰ Of course, welfare maximization is not the ultimate normative goal of the WTO, at least according to ordinary models of international trade rooted in Pareto efficiency. One must examine general government welfare functions or some other measure that accommodates alternative goals—such as income distribution—important to the political economy of Members.

IV. Are Export Subsidies Different?

Can the peculiar treatment of export subsidies be justified in economic logic? To be sure, export subsidies can distort trade. To achieve free trade, they would have to be eliminated—but so too do other trade barriers, such as tariffs. Whatever the legal foundation for the arbitrators' positions, economic theory does little to explain why export subsidies are accorded such unique status in the WTO.⁷¹

A. The Economic Logic of Export Subsidies

Under purely competitive conditions, the allocative effects of export subsidies and import tariffs are very similar when countries are too small to affect world prices. Export subsidies will raise domestic prices and distort both domestic production and consumption decisions. The same will be true of import tariffs.⁷²

When countries are large enough to affect world prices significantly, however, the impacts of these policies are more complex. Large export subsidies will reduce prices in the rest of the world, hurting foreign producers and helping foreign consumers. Tariffs imposed by large buyers will do the same: they lower world prices hurt foreign producers and help foreign consumers. But under these circumstances there is a crucial difference. Under competitive conditions, a country imposing a large export subsidy necessarily *reduces* its own welfare because, in addition to distorting domestic production and consumption, it reduces the world price of a product it is selling. By contrast, when a large country imposes a tariff, the costs of distorting domestic production and consumption will be offset by the improvement to welfare that comes from reducing the world price of a product that it is buying. If the impact of improving the terms of trade outweighs the deadweight losses due to imposing the tariff, the welfare of a country imposing a tariff could actually increase. Indeed, economic theory tells us that there is an optimal tariff that maximizes the difference between the efficiency costs of a tariff and the terms-of-trade gains.⁷³ The same logic suggests that for large countries there will

⁷¹ Bagwell and Staiger point out that while a tariff-liberalization agreement expands the volume of trade, an export-subsidy reduction agreement restricts the volume of trade. They argue that GATT rules against export subsidies “may represent a victory for exporting governments at the expense of importing government—and world—welfare.” KYLE BAGWELL & ROBERT STAIGER, *THE ECONOMICS OF THE WORLD TRADING SYSTEM* ii (2002).

⁷² See, e.g., PAUL KRUGMAN & MAURICE OBSTFELD, *INTERNATIONAL ECONOMICS: THEORY AND POLICY* 199 (2003).

⁷³ See Graaff, “On Optimum Tariff Structures,” 17 *REV. OF ECON. STUD.* 47 (1949-50); Johnson, “Optimum Tariffs and Retaliation” 21 *REV. OF ECON. STUD.* 152 (1953-54).

be an equivalent optimal tax—rather than subsidy—on exports.⁷⁴ The net welfare impacts of tariffs and export subsidies on the rest of the world are also very different. As a net exporter of goods subjected to tariffs, the rest of the world will lose from import tariffs. By contrast, as a net importer of the goods being subsidized, the rest of the world gains from export subsidies.

In conventional theory assuming perfect competition, therefore, the negative impact of export subsidies occurs at home. Why then do countries subsidize their exports? To explain this behavior as maximizing national welfare, the theory needs to be made much more complicated. Numerous arguments have been constructed. One line of argument, based on strategic trade, emphasizes the ability to shift rents under conditions of imperfect competition. For example, in a duopoly, when firms interact in the manner described by Cournot (reactions based on quantities), Brander and Spencer have shown that an export subsidy may shift rents from foreign to domestic firms (although again in this case the subsidies improve consumer and world welfare).⁷⁵ But this result is very sensitive to the assumptions about firm behavior: in response to the interaction assumed by Bertrand (reactions based on prices), the optimal policy could actually be an export tax, as Eaton and Grossman have shown.⁷⁶

A second line reasoning explores general equilibrium mechanisms that could improve a country's terms of trade. Robert Feenstra, for example, has shown that subsidizing some exports could stimulate the demand for complementary exports and, while lowering the prices of the subsidized products, could actually improve a country's terms of trade by increasing demand for the other products. (The same effect may help explain why casinos try to stimulate demand for gambling by giving away free food and lodging.)⁷⁷ Similarly, Itoh and Kiyono have shown in a Ricardian model how highly selective subsidies could improve a nation's terms of trade through

⁷⁴ On the equivalence of export and import taxes, see Abba P. Lerner, "The Symmetry between Import and Export Taxes" 3 *ECONOMICA* (Aug. 1936). There are cases when the optimal tariff could be negative; thus, equivalently, an export subsidy could be optimal. These cases occur when multiple equilibria are possible because a foreign country has alternative offers at the same terms of trade. See JAGDISH BHAGWATI & T.N. SRINIVASAN, *LECTURES ON INTERNATIONAL TRADE* ch. 17.4 (1984). See also Kemp & Negishi, "Domestic Distortions, Tariffs and the Theory of the Optimal Subsidy," 77 *J. OF POL. ECON.* 1011 (1969).

⁷⁵ Brander & Spencer, "Export Subsidies and International Market Share Rivalry," 18 *J. INT'L ECON.* 83 (1985). See also Kyle Bagwell & Robert Staiger, "Strategic Trade, Competitive Industries and Agricultural Export Subsidies," *NBER Working Paper*, No. 7822 (2000).

⁷⁶ Eaton and Grossman have shown this conclusion is very sensitive to assumptions about how firms behave. They present a duopoly model with a Cournot equilibrium where the optimal policy is an export subsidy, but with a Bertrand equilibrium where the optimal policy is an export tax. Jonathan Eaton & Gene Grossman, "Optimal Trade and Industrial Policy under Oligopoly," 101 *Q. J. ECON.* 383 (1986).

⁷⁷ Robert Feenstra, "Trade Policy with several Goods and 'Market Linkages'," 20 *J. INT'L ECON.* 249 (1986).

raising wages.⁷⁸ Finally, Kemp shows that there is an optimal export subsidy when there are factor market imperfections and externalities in the foreign country, leading to the possibility of multiple equilibria in its offer curve.⁷⁹ While all these theories do demonstrate the ability of export subsidies to raise national welfare, the general tenor of this work is that the prescriptions for welfare-enhancing export subsidies are not robust. Policy choices are quite sensitive to assumptions about competitive conditions, firm behavior, and the specific types of goods that are subsidized, as well as features of the foreign market.

To justify export subsidies under general conditions, however, it is necessary to drop the assumption that governments seek to maximize national welfare. Instead, the desire to redistribute income towards producers of exports needs to be given more weight. From a domestic perspective, governments that wish to raise the incomes of farmers, for example, may subsidize their farm exports despite the efficiency costs. When they do this though, if the subsidies are large, the reductions in the terms of trade will represent an additional cost for them and for producers in the rest of the world. Under these circumstances, as Bagwell and Staiger have shown, two (or more) large exporters seeking to redistribute income towards export interests may find themselves in a prisoners' dilemma game in which they have an interest in cooperating to limit the negative effects of their subsidies on each other (although this cooperation comes at the expense of foreign consumers and global efficiency).⁸⁰

In sum, assuming *competitive conditions*, conventional theory suggests that, if maximizing national welfare is the goal, export subsidies are generally counterproductive. Introducing considerations such as strategic trade, complementarities between goods, general equilibrium and political effects can rationalize such behavior, but only under particular assumptions. In most of these cases, agreements to limit such subsidies harm foreign consumers. While there may be some presumption that these subsidies could reduce global welfare, there are examples where they could be beneficial.

How might we evaluate the WTO treatment of export subsidies in the light of this economic theory? Let us deal with two questions. First, should export subsidies be prohibited? And

⁷⁸ Itoh Motoshige & Kazuharu Kiyono, "Welfare-Enhancing Export Subsidies," 95 J. POL. ECON. 115 (1987).

⁷⁹ Kemp, "Notes on the Theory of Optimal Tariffs," 43 ECON. REC. 395 (1967).

⁸⁰ Bagwell & Staiger, *supra* note 75. They find, however, that the most globally efficient solution actually involves *larger* export subsidies than the Nash equilibrium, which in turn involves larger subsidies than an agreement between the exporters to limit such subsidies.

second, should retaliation against export subsidies be divorced from nullification or impairment and consequently be made greater than retaliation against other infractions?

B. Should Export Subsidies Be Prohibited?

The WTO ban on export subsidies could be explained if all markets are basically competitive and countries seek to maximize national welfare.⁸¹ However, if these conditions were met, it would leave the puzzle of why governments subsidize exports in the first place, and why they need an agreement to do something that is in their own interest. It is more likely that some governments actually believe such practices are beneficial to them, but have agreed to a ban because it constrains others.

WTO members may care more about protecting their producers from the adverse competitive effects of export subsidies than about enhancing the welfare of their consumers through lower export prices.⁸² This preference for producer interests may well explain why the requirement for applying countervailing duties against foreign subsidies, for example, is material (producer) injury rather than reduced national welfare.⁸³ But it cannot fully explain the *per se* ban on export subsidies *without any injury test*—which therefore includes cases when foreign consumers benefit while foreign producers suffer no harm.

To justify absolute limitations on export subsidies, significant weight must be placed on the problems faced by governments confining their interventions to those cases in which they are theoretically justified. Embodying the ban in a trade agreement helps governments resist the pleas of rent-seeking producers.⁸⁴ Indeed, precisely because there may be plausible arguments in favor of export subsidies under circumstances that are hard to identify in practice,

⁸¹By contrast, countries may well be reluctant to ban tariffs and view tariff reductions as “concessions” because tariffs confer terms-of-trade benefits to large countries and allow even small countries to capture rents from foreign monopolists. See ELHANAN HELPMAN & PAUL KRUGMAN, *TRADE POLICY AND MARKET STRUCTURE* ch. 4 (1999).

⁸²For the argument that the countervailing duty laws are best understood as a means to protect domestic producers from the harmful effects of foreign subsidies, see Charles Goetz, Lloyd Granet, and Warren Schwartz, “The Meaning of ‘Subsidy’ and ‘Injury’ in the Countervailing Duty Law,” 6 *INT’L REV. L. & ECON.* 17-32; Richard Diamond, “Economic Foundations of Countervailing Duty Law,” 29 *VIRG. J. OF INT’L L.* 767 (1989).

⁸³For an argument advocating an injury test that looks for harm to aggregate welfare rather than only to producers, see Gene M. Grossman & Petros C. Mavroidis, “US—Lead and Bismuth II: United States—Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom: Here Today, Gone Tomorrow? Privatization and the Injury Caused by Non-Recurring Subsidies,” in *THE WTO CASE LAW OF 2001: THE AMERICAN LAW INSTITUTE REPORTERS’ STUDIES* (Henrik Horn & Petros Mavroidis, eds.) (2003).

⁸⁴See Giovanni Maggi & Andres Rodriguez-Clare, “The Value of Trade Agreements in the Presence of Political Pressures,” 106 *J. POL. ECON.* 574 (1998).

governments may need such help defending themselves. Clever export interests may seek to disguise their narrow interests in the guise of the national interest. Such pressures are particularly difficult to resist when exporters are forced to compete with foreign firms who receive export subsidies, and governments are asked to “level the playing field.”⁸⁵ However, it is not obvious that a trade agreement is the best self-restraint mechanism for *all* WTO members and superior in *all* cases to domestic mechanisms which prohibit such interventions (as the U.S. Constitution does in the case of export *taxes*).⁸⁶

In sum, the case for an export subsidy ban seems to ultimately rest on a judgment that the political and informational advantages of a complete ban outweigh the benefits that would result from greater government discretion. As Paul Krugman has observed, discussing strategic trade policies more generally, “There is still a case for free trade as a good policy, and as a useful target in the practical world of politics, but it can never again be asserted as the policy that economic theory tells us is always right.”⁸⁷

It is important to acknowledge therefore, that as with free trade generally, the WTO ban on export subsidies does not ultimately rest on a fool-proof theoretical justification. There are, in principle, some (second-best) circumstances in which export subsidies could serve a social purpose in allowing governments to redistribute incomes towards domestic producers, while at the same time providing benefits to the world as a whole. As such, it is hard to square the opprobrium that some observers believe such subsidies deserve under all circumstances. Theory does not readily justify the distinctive treatment of export subsidies.

The case for tolerating some export subsidies is even stronger when it comes to developing countries. Regarding export zones, the argument is, first, that domestic institutions are far from ideal in many developing countries and, second, wholesale changes are difficult to implement on political or practical grounds. Under these circumstances, it could make sense initially to apply new rules and regulations to particular zones, prior to their introduction to the entire country. In fact, this was precisely what China did when introducing its Special Economic Zones.⁸⁸

⁸⁵ A variant on this argument suggests that governments themselves may be tempted to act in an inconsistent manner over time. This temptation stems from the ability to use unexpected policies, and may lead to “time-inconsistent” policies. In these cases, a ban enshrined in an agreement could act as a pre-commitment device. *See, e.g.,* Staiger & Tabellini, “Rules and Discretion in Trade Policy,” 33 *EUR. ECON. REV.* 1265 (1989).

⁸⁶ U.S. CONST. art 1, par. 9, cl.5 (“No tax shall be laid on articles exported from any State.”)

⁸⁷ Paul Krugman, “Is Free Trade Passé?” 1 *J. ECON. PERSPECTIVES* 131, 132 (1987).

⁸⁸ *See* Graham, *supra* note 7.

One rationale for a ban on many of the subsidies associated with these zones is concerns about a “race to the bottom,” in which developing countries lose much of their advantage by competing against one another in granting concessions to foreign investors. But this concern is not confined to subsidies contingent on exporting, and should more appropriately be part of TRIMS.⁸⁹

However, export zones are not the only reason for avoiding *per se* bans on the export subsidies of developing countries. The SCM itself indicates that assistance for research activities should be permitted and non-actionable in all members.⁹⁰ This classification accords with the view that knowledge can be a public good, and therefore will be under-provided by purely private markets.⁹¹ However, especially for developing countries, an important collection of knowledge concerns activities in which the country has the ability to become an exporter.⁹² The key to successful innovation is not only discovering new technologies and inventing new products, but in determining which products and technologies can in fact make money in a particular setting. This activity too is one in which social benefits are likely to exceed those captured by private actors. While there are many practical problems associated with implementing such policies, it seems inappropriate to rule out any use of export subsidies to promote such endeavors.

As countries become more significant global competitors in certain products, there is a case for placing limitations on these practices if they adversely affect other countries. Indeed, once discoveries have been made, subsidies are arguably no longer required. But if countries are relatively small market participants, it is particularly hard to justify an absolute ban. For developing countries in particular, instead of the current blanket prohibition of export subsidies, an injury requirement and more lenient treatment with respect to *de minimis* market shares should be considered.

⁸⁹ For the case arguing for an agreement to limit such competition, see THEODORE H. MORAN, FOREIGN DIRECT INVESTMENT AND DEVELOPMENT: THE NEW POLICY AGENDA FOR DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION (1998).

⁹⁰ See SCM, *supra* note 4, art. 8 (identifying non-actionable subsidies). As noted earlier, these provisions are in abeyance. See *supra* note 20 and accompanying text.

⁹¹ See, e.g., Kenneth J. Arrow, “Economic Welfare and the Allocation of Resources for Invention,” in NATIONAL BUREAU OF ECONOMIC RESEARCH, THE RATE AND DIRECTION OF INVENTIVE ACTIVITY 618 (1982); PAUL A. SAMUELSON, ECONOMICS 151-52 (1980).

⁹² See Ricardo Hausmann & Dani Rodrik, “Economic Development as Self-Discovery,” 72 J. DEVELOPMENT ECON. (2003).

C. Is the Current Approach to Retaliation Justified?

There is even less support in economic reasoning for allowing larger or more stringent retaliation than in the case of other infractions.⁹³ Indeed, the simple economics of export subsidies suggest that the WTO approach is exactly wrong. Export subsidies are usually a gift to the world community at large—although foreign producers may be hurt, foreign consumers gain even more. Tariffs, however, penalize the rest of the world because the losses to producers outweigh the gains to consumers. If anything, therefore, the response to tariff violations should be harsher than the response to breaches involving export subsidies. In terms of economic theory, because the subsidies themselves will confer net benefits to third parties, “appropriate countermeasures” should be *less* than the level of nullification or impairment.

The approach adopted with respect to conventional countervailing duty measures, applied by countries on imports unilaterally, is more amenable to economic reasoning than “appropriate countermeasures.” By adding an injury requirement, such a tack suggests that domestic consumers should be allowed to benefit from lower subsidized prices—even if caused by prohibited export subsidies!—unless there is evidence of harm to producers. In strict economic terms, one might prefer more precision about the nature of the injury that should be offset, as well as a weighing of the damage done to producers against the benefits accorded to consumers.⁹⁴ It is difficult to explain, in economic terms at least, why the WTO would implicitly take consumer interests into account with respect to countervailing measures (allowing duties only when there is injury) but ignore them in the section of the SCM concerning prohibited subsidies (where impact on trade is not required for retaliation).

Economic theory also provides no rationale for the distinctive treatment of other prohibited subsidies—that is, subsidies “contingent upon the use of domestic over imported goods.”⁹⁵ A basic principle in microeconomics is that the allocation of resources responds to relative prices. The relative price of a good A in terms of B can be reduced either by a subsidy to A or a tax on B. Thus, for any subsidy there is an equivalent tax that achieves the same result. It is therefore

⁹³ To be sure, there is a case to be made that enforcement could lead to more compliance and thus the broader is standing the more likely is compliance but the issue here is whether the ban on export subsidies deserve *distinctive treatment*. For a discussion of enforcement see Robert W Staiger, “International Rules and Institutions for Trade Policy” Chapter 29 in Gene M. Grossman and Kenneth Rogoff (eds) *Handbook of International Economics Volume 3* Amsterdam: North Holland 1995

⁹⁴ See for example Grossman and Mavroidis op. cit.

⁹⁵ SCM, *supra* note 4, art. 3(b).

inexplicable why domestic subsidies that lower the relative price of domestic goods should be given the distinctive treatment associated with prohibited subsidies, whereas tax violations under GATT Article III—which raise the relative price of imports and achieve precisely the same allocative effect—are subject to normal dispute settlement procedures.

IV. Policy Implications

The absence of injury or adverse effect as a prerequisite for challenging export subsidies fundamentally changes the nature of WTO obligations. Every WTO Member is able to act, regardless of how the breach impacts them—conceivably, even if it didn’t impact them at all. Indeed, the missing injury requirement makes it possible for Members to win cases even when there is no damage to world community at large. The focus shifts from the damage caused to the act itself, a dangerous turn for any legal system. This detachment invites countries to use their power to threaten others, or to exact concessions which would otherwise not be forthcoming.⁹⁶ Enforcement is no longer a matter of remedy—allaying the disruption caused by a breach—but rather a matter of political whimsy, since there is no prudential gate on standing.

Similarly, the treatment of retaliation also fundamentally changes the system. Damages (nullification and impairment) are no longer the metric, only the amount of the subsidy plus or minus an arbitrary “compliance inducement” premium attached by the arbitrators. The application of “appropriate countermeasures” allows arbitrators free reign to implement remedies in accord with their own biases and prejudices as to the nature of WTO obligations. When the trade effect of a subsidy on a particular Member (and indeed all Members) is far less than the amount of the subsidy, it is hard to see how this is not punitive, despite the pains of the arbitrators in *US—Tax Treatment* to claim otherwise. Simply put, the amount of the remedy is in excess of the damage caused. Together, loose standing and vague remedies permit arbitrators to push, in practice, a theory of complete legalization, in which multilateral sanctions are used to force compliance.

One must question the normative value of these choices. Leaving aside the invitation to contradictory remedies, the present structure of export subsidies has permitted one theory of the WTO’s future—legalized rules enforced by punitive, or at least disproportionate, sanctions—to proceed without the benefit of explicit political choice. Few international lawyers will argue that WTO obligations, including Panel decisions, are not *legally binding*.⁹⁷ Rather, at issue are the consequences of a breach. In that context, it is important to highlight how far afield the

⁹⁶ To be sure, thus far, this right does not seem to have been abused. However, we are concerned largely with the *future* implications of such a feature for institutional design and developing countries.

⁹⁷ As John Jackson has argued, even if retaliation is authorized, there remains an international legal obligation to comply that is not eliminated. See John H. Jackson, “International Law Status of WTO Dispute Settlement Reports,” *supra* note 3.

treatment of export subsidies strays from the current consensus as reflected in the rest of the agreement.

There are numerous benefits that stem from the WTO practice of allowing commensurate retaliation, although several are imperfectly achieved.⁹⁸ Above all, it allows for the maintenance of reciprocity in obligations. It also provides incentives for compliance. It may partially compensate the plaintiff for some of the adverse effects of the violation, and it permits a form of breach without further consequences for an unspecified period of time thereby acting like a safety valve. Such a system also formalizes “tit for tat,” a response that is most likely to lead to cooperation in repeated games based on prisoners’ dilemma frameworks.⁹⁹ Finally, as Wilfred Ethier has shown, allowing only commensurate responses leads to an optimal degree of liberalization when parties believe they are as likely to be complainants as they are to be defendants.¹⁰⁰

For export subsidies, however, there has been a shift away from this paradigm.¹⁰¹ And the experience illustrates the dangers in such a change, as arbitrators have seized upon the language of “appropriate countermeasures” to move the WTO from a contract-oriented bundle of bilateral agreements toward a legalistic model more appropriate for a municipal system than an international one. The awards of the arbitrators have increased the power of those with the ability to retaliate at the expense of those that do not. Big players like the United States and the European Union can use this unique pressure point in ways that Mauritius or Ecuador cannot. And there is also no check, no mechanism by which the Appellate Body can constrain awards or reign in arbitrators.¹⁰² True, some may argue that the advantage of this approach is that it will induce more compliance. But ironically, as we have seen, export subsidies are a practice in which the parties have the greatest incentives to comply, while compliance may actually reduce welfare in the rest of the world as a whole.

⁹⁸ For a more extensive discussion see LAWRENCE, *supra* note 3.

⁹⁹ See ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984).

¹⁰⁰ Wilfred Ethier, “Punishments and Dispute Settlement in Trade Agreements,” *Copenhagen Economic Policy Research Institute Working Paper* (2001).

¹⁰¹ Cf. Judith H. Bello, “The WTO Dispute Settlement Understanding: Less Is More,” *supra* note 3; John H. Jackson, “The WTO Dispute Settlement Understanding: Misunderstandings on the Nature of Legal Obligations,” *supra* note 3; Warren F. Schwartz and Alan O. Sykes, “The Economic Structure of Renegotiation and Dispute Resolution in the WTO/GATT System,” *supra* note 3.

¹⁰² Richard Steinberg argues that political considerations keep the Appellate Body in check, but that this effect is likely to be much less of a constraint on members of Panels (who are not permanently engaged in dispute settlement). See Richard H. Steinberg, “Judicial Lawmaking at the WTO: Discursive, Constitutional, and Political Constraints,” 98 AM. J. INT’L L. 247 (2004).

A. Looking to the Future of the WTO: The Exception that Proves the Rule

This shift from re-balancing concessions to “inducing compliance” reverberates far beyond the narrow exception of export subsidies. As tariffs creep ever-lower, lowering non-tariff barriers to trade becomes the chief task of the WTO. Export subsidies provide a working model of how the WTO might approach future rounds of liberalization in an array of areas.

We emphasize that our horizon is broad. In deriving some tentative conclusions from the export subsidy model, we do not seek to forecast the results of the Doha Round. Rather, we are concerned with what the export subsidy experience can tell us about the long-term trajectory of WTO institutional design. If trade liberalization is to continue in the multilateral framework, two general paths to enforcement are possible. One is simply to forget it, or to rely on the ordinary mechanisms of international pressure. That path would freeze the current scope of the DSU or simply tinker around the edges. The second option is to try and expand the DSU to cover the new, non-tariff challenges—everything from technical barriers to labor standards to investment rules—that may be addressed in a WTO framework. Difficulties in valuation, domestic political interests, and institutional capacity all point to *some* move away from the rebalancing rubric: the question is what the transformation will look like. Assuming that the DSU will be expanded, not abandoned, the treatment of export subsidies illuminates what *one* variant of possible transformation would look like.

To that extent that export subsidies illuminate a future path for the WTO as a whole, it suggests a theoretical drift that should be worrisome. International lawyers tend to be overwhelmingly optimistic when it comes to compliance with treaties like the WTO Agreements. And experience bears their intuition out, at least with respect to the simple correlation between international agreements and state behavior. In the famous words of Louis Henkin, “almost all nations observe almost all principles of international law and almost all their obligations almost all of the time.”¹⁰³ But important strands of legal literature are now asking *why* this correlation is true—if in fact it is—and *how* international law actually influences states. Traditional international relations scholars argue that the law is epiphenomenal, that it merely reflects the

¹⁰³ Louis Henkin, *How Nations Behave* 47 (2d ed. 1979) (emphasis omitted).

balance of state interests.¹⁰⁴ Taking these interests as given, regime theorists have allowed that international institutions like the WTO perform an important function of communicating these interests and allowing for mutual gains through cooperation—a line of reasoning that has been taken up by some legal scholars.¹⁰⁵ Another strand argues that international law itself has important persuasive or socialization functions that gradually *change* state interests.¹⁰⁶

Though they may seem esoteric, these legal theories bear directly on what one makes of the shift in the WTO suggested by the treatment of export subsidies. If the WTO is really just a shop for expressing interests and generating mutual gains through cooperation, then “inducing compliance” through highly punitive measures is a recipe for disaster. Depending on their preferences, Members could simply walk away as the costs of the regime increase relative to the benefits gained by participation.¹⁰⁷ At a minimum, they will become increasingly reluctant to assume new obligations.

The approach on export subsidies—both on nearly universal standing and non-equivalent retaliation—powerfully increases the costs of the WTO relative to its benefits. It has given credence to those who argue that the WTO has established a different and more powerful legal order than GATT, representing a greater threat to national sovereignty.¹⁰⁸ It also highlights inequalities among WTO Members, imbuing some with the ability to act as enforcers while others cannot. It creates a considerable danger of escalating retaliation. Finally, it raises the prospects that the WTO could actually lead to more protection than in its absence. For example, in *US—Tax Treatment*, if the EU had imposed the 100 percent tariffs on \$4 billion worth of U.S.

¹⁰⁴ See generally NEOREALISM AND ITS CRITICS (Robert O. Keohane ed., 1986). See also KENNETH N. WALTZ, THEORY OF INTERNATIONAL POLITICS (1979). Waltz’s structural theory of international relations built on the seminal work, HANS J. MORGENTHAU, POLITICS AMONG NATIONS: THE STRUGGLE FOR POWER AND PEACE (3rd ed. 1960) (1948).

¹⁰⁵ See, e.g., JACK GOLDSMITH & ERIC A. POSNER, THE LIMITS OF INTERNATIONAL LAW (2005) (offering a rational choice theory of international law to predict state behavior); Andrew T. Guzman, “A Compliance-Based Theory of International Law,” 90 CAL. L. REV. 1823 (2002) (theorizing international law in part on the avoidance of adverse reputation consequences).

¹⁰⁶ See, e.g., Harold Hongju Koh, “Why Do Nations Obey International Law?” 106 YALE L.J. 2599 (1997) (structuring a theory of “transnational legal process” culminating in the domestic internalization of international legal norms); THOMAS M. FRANCK, THE POWER OF LEGITIMACY AMONG NATIONS (1990) (theorizing that the legitimacy of norms caused them to exert a greater “compliance pull”); Ryan Goodman & Derek Jinks, *How to Influence States: Socialization and International Human Rights Law*, 54 DUKE L.J. 621 (2004) (arguing that acculturative processes should be treated distinctly from coercive and persuasive ones).

¹⁰⁷ Cf. Chad P. Bown, “On the Economic Success of GATT/WTO Dispute Settlement,” 86 REV. ECON. & STAT. 811 (2004) (arguing that the economic success of disputes is predicated on economic power).

¹⁰⁸ See, e.g., CLAUDE E. BARFIELD, FREE TRADE, SOVEREIGNTY, DEMOCRACY: THE FUTURE OF THE WORLD TRADE ORGANIZATION (2001).

exports, it would have raised the average import-weighted tariffs on U.S. exports to the EU by 1.8 percent. Judged in terms of liberalization achieved in trade negotiations, this is a significant increase: according to the World Bank, the EU countries reduced their import-weighted average tariffs by an estimated 1.6 percentage points in the Uruguay Round.¹⁰⁹

However, if we proceed from an institutionalist (regime) theory, steeper penalties or tighter rules might be supported. Indeed, Abram and Antonia Handler Chayes have built an entire case for compliance with international law based upon the careful improvement of such rules and their consequences.¹¹⁰ If interests can be more easily communicated, coordination is enhanced and equilibria will exist even when non-communicative parties would be predicted to withdraw. But coordination will be strained as costs increase in a rules-based system, since state interests remain given, or at least “sticky.”

More liberal theories of international law and institutions are more sanguine about rules, but a closer examination also warns of trouble. Suppose state interests can be changed by persuasion or socialization; that is, countries can be “taught” free trade or “acculturated” to believe that free trade is what modern nations do. According to such theories, states eventually comply with or obey international law because they believe it’s the right/best thing to do, or because they simply don’t think to act otherwise. In other words, the state comes to the active and positive belief that the norm should be adopted, or is immersed in a global culture that instills that belief through more subtle channels. Unlike the interest-based inquiries of the regime theorists, proponents of persuasive and acculturative theories argue that true “compliance” is possible without an initial coincidence of interests. All parameters change if interests are modifiable. In other words, a state can come to act in support of a norm even if the costs are substantial. Punishing non-compliance, as with export subsidies, then could be an effective method for achieving compliance. After all, if the state truly believes the proper norm is to refrain from export subsidies, then the punishment is merely reinforcing its own interests.

International lawyers, of course, tend to implicitly assume these theories when prescribing solutions—like “appropriate countermeasures.” But even if their theories are accurate predictors of how states behave, imposing a punitive, unequal enforcement mechanism a la export subsidies

¹⁰⁹ J.MICHAEL FINGER, MERLINDA D INGCO AND ULRICH REINCKE THE URUGUAY ROUND: STATISTICS ON TARIFF CONCESSIONS GIVEN AND RECEIVED (1996)

¹¹⁰ ABRAM CHAYES & ANTONIA HANDLER CHAYES, THE NEW SOVEREIGNTY: COMPLIANCE WITH INTERNATIONAL REGULATORY AGREEMENTS (1995) (developing a theory of “managerialism” to explain compliance in treaties). The Chayes’s theory also draws on the persuasion to explain international law’s effect on states.

is not necessarily the way to operate. First, true persuasion requires a change in interests or beliefs without such a bluntly coercive stick. A state has not necessarily been persuaded to adopt a norm if it must be punished; its behavior respecting the norm might just be its interest in avoiding punishment, hardly a sustainable solution.¹¹¹ Second, the inequalities of such an approach will entrench divisions, making any sort of enduring socialization impossible. After all, how will countries come to behave as if “free trade” is best policy if they’re punished by policy tools they can scarcely use themselves? Inequality and exclusionary effects create resentment and suspicion that makes social mechanisms of change impossible.

Therefore, one need not be a hard-nosed economist or neo-realist scholar to be suspicious of the theoretical drift embodied in export subsidies. Most international lawyers and legalists, including the arbitrators in *US—Tax Treatment*, *Brazil—Aircraft*, and *Canada—Aircraft II*, implicitly proceed from a theory that suggests state interests can be changed through persuasive or acculturative processes. But without specifying the causal pathways or mechanisms of those processes, institutional design suffers. Awards, rather than flowing from a cohesive idea of how best to induce compliance, become arbitrary and divisive, limiting the constructivist influence that WTO rules and DSB decisions might have. The experience with export subsidies is a glaring example of how institutional design falters when causal pathways have not been clearly thought through. It is a warning to those who would take the efficacy of international law for granted.

At the very least, the shift suggested by the export subsidies arbitrations is certainly not one that should be made without an explicit affirmation by the Members. When legal scholars draw such qualitatively different implications from the same language, it is surely an indication that it’s time to go back to the negotiating table. The coercive mechanism and lack of transparency endangers any sustainable, thorough transformation of protectionist Members’ interests. Reciprocity and rebalancing, whatever one’s opinions of their normative effects, are historically at the root of how the WTO is conceptualized. The health of the WTO system depends on recognizing that subtle cracks in the re-balancing schema, without explicit discussion or

¹¹¹ See, e.g., Jeffrey T. Checkel, “Why Comply? Social Learning and European Identity Change,” 55 INT’L ORG. 553, 562 (2001); Jeffrey T. Checkel, “Persuasion in International Institutions,” *ARENA Working Paper*, No. 02/14 (2002); Thomas Risse, “‘Let’s Argue!’: Communicative Action in World Politics,” 54 INT’L ORG. 1 (2000) (applying Jürgen Habermas’s critical theory to international relations); Ian Johnstone, “Security Council Deliberations: The Power of the Better Argument,” 14 EUR. J. INT’L L. 437, 440-50 (applying theories of Ronald Dworkin, Stanley Fish, and Habermas to explain legal persuasion in the Security Council).

implementation, foretell a doomed international regime, unless causal mechanisms are properly traced and implemented.

B. The Unique Impact on Developing Countries

Crucially—particularly for the Doha “development” round—both the current approach to export subsidies and the broader implications for the WTO are of most concern for developing countries. First, most of the developing world consists of small countries that do not enjoy benefits to their terms of trade and are less likely to use retaliation—or be able to withstand it. To date, only one large developing country, Brazil, has been the defendant in an export subsidies case that has involved permission for retaliation, but this situation is unlikely to be the last. Some developing countries have been given extensions of their exemptions from the provisions of Article 4 until the end of 2007.¹¹² A number of developing countries (e.g. Malaysia, Brazil, Mexico, Mauritius, India, and China) have used export zones as a fast-track mechanism to attract foreign investment and stimulate growth without having to undertake difficult domestic institutional changes. These countries are likely to be challenged if they continue with these policies; their violations will therefore be treated more harshly than those under other WTO provisions.

Second, the deeper “legalization” of the WTO embodied in the arbitrators’ approach to export subsidies has more far-ranging implications for developing countries. Proponents of the rule-based system sometimes claim that stricter, tighter rules are superior for the developing world, especially when backed by compliance-inducing “sanctions,” even fines. The theory is that contract-oriented systems allow powerful countries to leverage their weight, and rules-based systems protect weaker, often developing countries. Fair enough. But again, this theory begs the question of how international legal instruments actual operate to influence states.

If one takes the interest-based approach common in the international relations regimes literature, then a rules-based system is only as good as its ability facilitates cooperation. If rules outpace the coincidence of interests—as they arguably are in the case of export subsidies—then defection is encouraged. Because defection (and the commensurate ability to withstand retaliation) is an option open only to rich countries, the claim that rules “protect” developing

¹¹² Those countries that engaged in annual consultations and received additional extensions were to be subject to the more standard remedy provisions of Article 7, requiring injury and allowing “countermeasures commensurate with the degree and nature of the adverse effects.” SCM, *supra* note 2, art. 7.9

countries is disingenuous. Rather, while rich and poor countries are both “constrained” on paper, only the developing countries are truly limited.

If one takes the conventional international lawyer’s perspective that legal instruments can change state interests, then developing countries must question whether punitive mechanisms are the best way to “teach” or “acculturate” states. The natural impulse is to laud decisions like *Canada—Aircraft II* or *US—Tax Treatment* as bringing developed countries to heel. It is akin to seeing a white-collar criminal finally get his comeuppance. But if the scofflaw Member can simply pay a large “fine” to escape punishment, we are again left with an unequal system where those who can afford it go free and those who cannot afford it must comply. The deviant Member hasn’t necessarily been persuaded, its interests changed—compliance is merely a matter of national wealth. Greater penalties do not necessarily mean changed interests.

The point is that no coherent theory of how international law works can easily explain how the export subsidies approach to a rules-oriented system is any better or worse for developing countries than a contract-oriented approach predicated on re-balancing. Yes, all Members “must” abide by the rules. But positive theories that attempt to explain how rules impact compliance suggest, at the very least, that the approach to export subsidies will be no more effective than the rebalancing paradigm. In fact, these theories suggest that the impact of the export-subsidies approach will fall disproportionately on developing countries. Thus, to the extent that the approach to export subsidies suggests a broader drift in the WTO, developing countries have pause for concern.

V. Policy Recommendations

Export subsidies should be treated like other WTO violations. The case for treating them distinctively is weak. This treatment cannot be justified on economic grounds, and it represents a dangerous deviation from the basic tenets of the rest of the WTO legal system. Accordingly we suggest:

- (a) *Standing and retaliation should require some quantum of injury.* Standing to bring challenges to export subsidies should be similar to that under Article 7.1 relating to Actionable Subsidies. That is, standing should be confined to those members that have reason to believe that the export subsidies result in serious injury to its domestic injury, nullification or impairment or serious prejudice.
- (b) *Remedies should be equivalent to the level of nullification and impairment.* There may be a time when the WTO and Member interests are ready to support heftier punishments for infractions, but both theory and practice suggest its current use is premature. “Appropriate countermeasures” should be clarified, establishing a return to rebalancing with allowance for the difficult calculations involved in determining the impact of subsidies.
- (c) *Parties should be allowed to seek contingent authorization for retaliation at the time of the initial Panel.* Rulings should be provided by Panels on both the matter under dispute and the amount of retaliation in the initial Panel report, of course contingent on non-compliance. Appellate review should involve adjudication of both the panel decision and its proposed authorization for retaliation.
- (d) *Developing countries should be accorded special and differential treatment.* Subsidized exports by developing countries should not be able to be challenged if they constitute *de minimis* market shares. The injury requirement applied should be more lenient—for example, a reduction in national welfare in which consumer benefits are offset against producer injury.