CHAPTER 3

DISPUTE SETTLEMENT AND ENFORCEMENT OF RULES

In contrast to most international organizations that rely on diplomatic means to resolve conflicts, WTO dispute settlement (DS) procedures are elaborate and legally binding. This chapter first briefly presents a number of conceptual considerations that help to understand the role and nature of the WTO dispute settlement system. We then describe the major features of the system and discuss its operation to date as reflected in the case load between 1995 and 2007. The chapter concludes with a discussion of systemic questions and proposals that have been made to make the system more effective, both in the context of a review of the DS system by WTO members themselves and by the academic community, practitioners, NGOs and the business community.

3.1. The Rationale for a Dispute Settlement Body

Effective enforcement of negotiated commitments is a pre-condition for the trading system to work. Because the WTO is an inter-governmental agreement, it

must be what economists call 'self-enforcing'. There is no supra-national body that can impose rulings and enforce judgements. Instead, compliance with a negotiated agreement must come about because not doing so will result in a situation that is worse than the one that prevails if governments stick to their deals. Insofar as a government judges that defection is in its interest at a given point in time, cooperation can only be maintained if there is a credible threat by other WTO members that reverting back to a noncooperative policy stance will be punished by retaliation. This (threat of) retaliation must generate expected costs that are larger than the short-term gain from violating an agreement. In the WTO retaliation is exercised by the country or countries that are injured by the adoption of a policy that violates a prior agreement. They must enforce the terms of a deal themselves.

This immediately raises the question of why a Dispute Settlement Body (DSB) is needed. This is less obvious than it may appear. For example, Hungerford (1991) argues that a DSB may create incentives for members of a trade agreement to deliberately generate a dispute because they know it will be resolved. One rationale for the creation of a DSB is to reduce the prevalence of opportunism and use of (unilateral) retaliation by creating a presumption that action by a country to change the negotiated terms of a deal will result in compensation. The DS mechanism provides an objective forum in which the facts of a matter can be determined (through an exchange of information and independent evaluation) and where as a result 'excessive' retaliation (an immediate 'tit-for-tat' response) can be avoided (Bagwell and Staiger, 2002).

Simple theoretical analyses of DS mechanisms assume that enforcement of a specific negotiated contract occurs in a situation of certainty: violations are observed and are unambiguous. In practice, however, there will often be uncertainty regarding whether or not a certain policy measure violates the WTO. As will be seen repeatedly in subsequent chapters, the disciplines of many WTO agreements are often fuzzy, ambiguous or simply not defined. As a result there can easily be legitimate uncertainty regarding the appropriate interpretations of a provision in a specific context. For example, a measure that appears to violate a tariff binding or a negotiated commitment may in fact be permitted because it is a legal domestic tax that is collected at the border. Disputes then may involve disagreements in how to interpret a provision. Over time a body of case law reduces the associated uncertainty. Thus, the DSB can help address one form of contractual incompleteness that is inherent in the WTO—the vagueness of many of its disciplines—by interpreting the contract, filling gaps on specific matters where the treaty is silent, or, granting exceptions and thereby modifying certain aspects of a discipline. The latter implies that a dispute may serve as a mechanism to facilitate a form of 'efficient breach' of an agreement (Lawrence, 2003).

Thus, by spelling out more clearly what the applicable disciplines are, the DSB serves to reduce uncertainty regarding the legitimacy of certain types of measures, in the process reducing the use of unilateral retaliation against perceived violations of an agreement that are in fact due to exogenous shocks to demand or supply and not

driven by policy. More generally, the DSB can counteract the moral hazard problem that is likely to arise as a result of each WTO member interpreting vague provisions in a manner that suits its interests. Moreover, by providing a forum in which deviations can be publicized, other WTO members may be brought into the picture who also have an incentive to see cooperation sustained (Maggi, 1999). Finally, the DSB can help identify where negotiations are needed to clarify disciplines.

It is often stressed by economists that the WTO is an 'incomplete contract'. This implies that it does not (and cannot) specify what is permitted of governments in every state of the world. Instead, the WTO contains only a few specific, unambiguous disciplines (the most obvious being the tariff bindings). Other fundamental disciplines—such as national treatment—will require interpretation to determine if and how they have been violated in a specific instance. That is, a dispute may be needed to determine the ambit of the discipline in a specific, contested circumstance and the relevant facts. Horn and Mavroidis (2007) argue that the role of the DSB is to ease a coordination problem confronting WTO members by specifying an agreed-upon procedure for adjudication. Through the creation of the DSB, WTO members can circumvent the problem of agreeing on the specifics of the contract by agreeing to let a third party—panels and the Appellate Body (AB)—adjudicate on their behalf. In effect, the resulting rulings are accepted by the parties as an acceptable outcome of a negotiation they never completed or they generate new negotiations to clarify the applicable law.

For the DSB to play a role in 'completing' the WTO contract, and, in particular, to address instances of vagueness in language, rulings need to establish a precedent. In principle, dispute resolution under the WTO does not formally establish a precedent in that panels are not required to conform to the reasoning of prior panels or AB rulings, nor is the latter legally bound to follow its own prior case law. It is often argued that this approach has its roots in the GATT tradition of 'negotiated' dispute settlements where finding a pragmatic solution to a trade conflict was more important than legal consistency (Hudec, 1993), but it arguably has its roots in international law more generally. The fact that any resolution to a dispute did not create a precedent facilitated adoption of the panel reports by the council: every contracting party was reading panel reports with the 'skeletons in their closets' in the back of their minds (Mavroidis, 2007). In practice, however, given similar factual issues, there is a very high likelihood that WTO panels will follow AB rulings. The AB has made clear that its rulings should be applied by subsequent panels. For example, in 2007 a panel went against AB rulings that zeroing in antidumping (see Chapter 9) was WTO-inconsistent. The AB overturned the panel, stating that panels are expected to follow previously adopted AB reports addressing the same issue. It noted that failure to do so would undermine the development of a coherent and predictable body of jurisprudence.

The objective of DS in the WTO is to maintain the balance of negotiated concessions. This explains why the remedy in WTO dispute settlement is *prospective*: the

offending member is called upon to bring its measures into compliance. Whether this is enough of an incentive is a question to which we return below—many commentators argue it is not and would prefer to see a system that offers affected countries compensation for injury incurred as well as the standard WTO remedy, that is, *retrospective* measures. Prospects for this are not bright, in part because it would change the nature of the WTO. The relatively weak enforcement mechanisms in the WTO reflect the incomplete nature of the WTO contract: there is presumably a reason why governments signed a deal that is fuzzy in a particular area. For example, this may reflect trade costs—see Horn, Maggi and Staiger (2006)—which in practice are still quite significant (see Anderson and van Wincoop, 2004). The result will be that governments will not want to subject themselves to a process where they are subject to penalties that they deem inappropriate given the absence of *ex ante* specificity on the rules that will apply. This may be so in particular for countries that expect to be both complainants and respondents over time—likely to be the case for any large player. As noted by Ethier (2001*a*), this gives countries an incentive to agree to remedies that are limited in scope—that is, to design the DS mechanism to weaken remedies rather than strengthen them. Given that in any dispute the complainant has a clear incentive to push for maximalist remedies (the equivalent of criminal versus civil damages in a domestic setting), *ex ante*—that is, in designing the agreement, before any disputes have been brought—the participants in a trade negotiation may conclude that they are better off if DS is delegated to a third party that is constrained to recommend a remedy focused on maintaining the original balance of concessions. Strong enforcement can have the perverse effect of inducing countries to make fewer commitments in the first place, resulting in an outcome that is inferior to one where there is weaker enforcement—in that the expected benefits of cooperation are higher (Lawrence, 2003).

3.2. WTO Dispute Settlement Procedures

World Trade Organization dispute settlement procedures may be initiated whenever a member desires. This requires that the member claim that an action by another member has 'nullified or impaired' a concession that was negotiated previously (such as a tariff binding) or breaks a WTO rule and 'impairs the attainment of an objective' of the WTO. In the case of goods, complaints may take three forms (Article XXIII GATT). The first is a violation complaint, which consists of a claim that one or more disciplines or negotiated commitments have been violated. Second, members may bring a 'nonviolation' complaint: this allows a government to argue that a measure nullifies a previously granted concession

even though no specific rules are violated (Article XXIII: 1*b*). The third possibility is a so-called situation complaint, under which a member may argue that 'any other situation' not captured by the violation or nonviolation options has led to nullification or impairment of a negotiated benefit. (The latter is of very little practical significance.) Both GATS and TRIPS allow for both violation and nonviolation complaints, although in the case of TRIPS WTO members have agreed not to invoke the nonviolation provision until the TRIPS Council has determined the scope and modalities for such complaints. Article 64 TRIPS calls for this to be done within five years of the creation of the WTO, but as agreement proved impossible, members have periodically agreed to extend the moratorium, most recently at the 2005 Hong Kong ministerial meeting.

In theory, nonviolation cases could be important to the functioning of the system as they provide a way for members to contest the effects of policies that reduce the value of negotiated concessions but that are not subject to WTO disciplines. Countries such as the US have a tradition of using unilateral trade actions to defend their commercial interests in such instances. Section 301 of the Trade Act of 1974, as amended, allows (and sometimes requires) the US Government to take unilateral retaliatory actions against alleged unfair trading practices of partner countries. In principle, a nonviolation dispute is the WTO instrument to pursue such cases—although in practice they are very rare and hardly ever successful.

Disputes arising under any WTO agreement are dealt with by the DSB, which has the authority to establish panels, adopt panel reports, scrutinize implementation of recommendations and authorize retaliatory measures if the losing party to a dispute does not abide by the panel's recommendations. The DSB is essentially the WTO Council—it simply changes name when it considers disputes. The rules of the game are laid out in the Uruguay Round Dispute Settlement Understanding (DSU). The DSU covers all disputes arising under WTO agreements—that is, relating to GATT, GATS and TRIPS. The same procedures are used for settling disputes across all issues—there is a unified dispute settlement mechanism. However, some of the specific Uruguay Round agreements discussed in Chapter 5 contain special DS provisions. If these procedures differ from the general WTO provisions, the special procedures apply.

The use of WTO dispute settlement mechanisms is mandatory in all instances where a dispute concerns matters on which agreements have been concluded. If a member decides to pursue a dispute it must submit the case to the WTO adjudicating bodies (Article 23.2 DSU). It may not go ahead and retaliate. Article 23 DSU was important for many countries because it was aimed at disciplining the US use of 'aggressive unilateralism' (Bhagwati and Patrick, 1990). Only if a member does not comply with the outcome of the process, and the DSB authorizes retaliation may instruments such as Section 301 be used to retaliate. Even then, the magnitude of the retaliatory measures that may be imposed must first be determined by the WTO (Box 3.1).

Box 3.1. Settlement of disputes

Stage I: Consultations. Members must initially attempt to solve their disputes through bilateral consultations. The good offices and conciliation by the WTO Director-General may also be sought. The goal of the consultation stage is to enable the disputing parties to understand the factual situation and the legal claims and hopefully to settle the matter bilaterally. The objective of the DS process is to facilitate a settlement—Article 3.7 DSU specifies that a 'solution mutually acceptable to the parties to a dispute and consistent with the covered agreements is clearly to be preferred' to the formation of a panel. At any stage in the DS process the parties may reach an informal settlement (this is termed a mutually agreed solution (MAS) in WTO speak). Parties may also invoke mediation (Article 5 DSU).

Stage II: Request for a panel. If parties are not able to settle their dispute through consultations within 60 days, the establishment of a panel may be requested. Other WTO members may join as co-complainants if the original complainant accepts them (Article 4:11 DSU). The DSB establishes a panel, drafts terms of reference and determines its composition. Drawing on a large roster of potential panellists (who have all been nominated by WTO members), the WTO Secretariat suggests the names of three or four potential panellists to the parties to the dispute. Parties have the right to object to a proposed panellist. Panellists serve in their individual capacity, may not be subjected to government instructions, and tend to be members of delegations or retired civil servants knowledgeable in trade matters. They may also include academic scholars. The WTO Secretariat provides administrative support and generally prepares the background documentation regarding the facts of the case.

Stage III: The panel at work. The panel usually goes through the following steps in pursuing its mandate to perform an objective assessment of the facts and the applicability of and conformity with the relevant WTO agreements: (1) examination of facts and arguments; (2) meetings with the parties and interested third parties (those with a 'substantial interest' in a dispute (Article 10 DSU); (3) interim review—descriptive and interim reports are sent to the parties, who may request a review meeting with the panel; (4) drafting of conclusions and recommendations; and (5) issuing of their report to the parties and circulation to the DSB. Panels have power of discovery: they may seek information and technical advice from any appropriate body or person (Article 13 DSU), and issue questionnaires to the parties in a case. Panels are supposed to conclude their work within 6 months, and exceptionally, 9 months. In practice the average is slightly over one year.

Stage IV: Adoption decision or appeal. The panel report must be adopted by the DSB within 60 days, unless a consensus exists not to adopt, or a party appeals the findings of the panel. Appeals are supposed to be limited to issues of law or the legal interpretation developed by the panel, although in practice this restriction is not necessarily a binding one. An Appellate Body, composed of seven persons who are broadly representative of the WTO's membership, deals with such appeals. Appeal proceedings should not exceed 60 days and must be completed within 90 days. The AB is limited to judging matters of law and the legal consistency of panel reports. It has some discretion in key areas—for example in determining who has the burden of proof, a question on which it has reversed panels. The AB report is final and is adopted by the DSB.

Stage V: Implementation. If it is impracticable to comply immediately, the offending country is given a 'reasonable period of time' to do so (Article 21.3 DSU). The length of this

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Box 3.1. *(Continued)*

period can, at the request of the parties, be determined through binding arbitration. If the respondent fails to act within this period, parties are to negotiate compensation pending full implementation (Article 22.2 DSU). If this cannot be agreed, the complainant may request authorization from the DSB to suspend equivalent concessions against the offending country (that is, to retaliate). This authorization is automatic (as a consensus is needed to refuse it).

The magnitude of the retaliation is determined by the DSB, generally on the recommendation of the original panel. Arbitration may be sought on the level of suspension, the procedures and principles of retaliation (Article 22.6). Retaliation is intended to be temporary, until such time as a member has brought its measures into compliance—the basic objective of the DSU. In principle, retaliation occurs under the same agreement, but the choice of sector/product is left to the discretion of the WTO member. If retaliation is not feasible under the same agreement that was invoked in the dispute, a member may ask the DSB for authorization to suspend concessions under another agreement.

If there is disagreement whether the respondent has brought its measures into compliance, recourse is to be made to the DS procedures. That is, the process starts again, using where possible the original panel, but subject to an accelerated time frame (90 days) (Article 21.5). As discussed below, such Article 21.5 compliance panels have played a prominent role in a number of key cases brought to the WTO. One reason is that panels rarely make specific recommendations: it is left to the WTO member concerned to bring its measures into compliance.

Dispute settlement under GATT and WTO

Dispute settlement under the GATT was based on the consensus principle. This ensured that both parties to a dispute had to agree on the outcome, increasing the likelihood of implementation. It also created opportunities for parties to a dispute to block either the initiation or the completion of the process. This could be achieved through refusal of one of the parties to a dispute to agree to the formation of a panel, to delay the appointment of a panel or to refuse to adopt the panel report. In the 1980s and early 1990s, a growing number of fractious trade disputes that could not be resolved gave rise to concerns regarding the effectiveness of GATT dispute settlement procedures. These disputes reflected the intensification of competition resulting from changing patterns of comparative advantage, as well as vaguely worded GATT provisions and differences in their interpretation in key areas such as subsidies and agriculture. A number of the disputes that were brought to the GATT in the 1980s were essentially attempts by contracting parties to more clearly define GATT provisions—they substituted for negotiations. It is therefore not surprising that they were controversial.

In practice, GATT contracting parties made only limited use of the consensus rule to block dispute settlement. Legal research has concluded that the GATT dispute

mechanism worked much better than was generally recognized. Of some 278 complaints considered under general DS provisions between 1948 and 1994, 110 led to legal rulings by panels, the others being settled before a report was produced. Of the 88 cases where the panel found a violation had occurred, the majority were adopted. Moreover, many of those not adopted did lead to a satisfactory outcome. Hudec (1993) found that overall, over the life of the GATT 1947, the success rate of cases addressed by GATT—that is, disputes settled—was well over 90 per cent. After 1980, the rate of nonadoption of panel reports increased significantly, reflecting the fact that many of the contested issues were in areas where the rules were not clear or that were the subject of ongoing negotiations during the Uruguay Round.

The success of a system that could so easily be blocked by one party to a dispute can be explained in large part by self-interest. Losing parties knew that at some point in the future they would bring cases themselves. If they were to block disputes or adoption of reports this would greatly reduce the value of negotiated commitments. The GATT (and the WTO) is a repeated game (see Chapter 4)—parties know they will interact over an indefinite time horizon. As noted by Hudec (1993), other factors were that GATT contracting parties 'owned' the agreements and that the disciplines of the GATT generally made good economic sense. In many cases, officials of countries that lost a case had an interest in enforcing GATT rules because it helped them adopt more efficient instruments of trade policy.

Compared to the GATT 1947, dispute settlement under the WTO was strengthened by eliminating the possibility of blocking the formation of a panel and the adoption of panel reports, introducing time limits for the various stages of panel proceedings, defining standard terms of reference for panels, creation of an appeals process and automaticity of approval for retaliation in cases of noncompliance with a panel recommendation. Under the WTO, adoption of panel reports can only be blocked by a 'negative consensus', that is, all WTO members must agree that the panel report is fundamentally flawed, a highly improbable event. To counterbalance the removal of the blocking option for losing parties, Uruguay Round negotiators created a new standing Appellate Body. This entity—essentially an appeals court—can be asked to consider challenges regarding the legal interpretations of a panel. It comprises seven members, appointed for four years, renewable once. Thus, one outcome of the Uruguay Round was to shift towards a two-stage process, under which panels become akin to lower level courts, albeit a court with constantly changing composition, as panellists (judges) are drawn from a roster and are appointed on a case-by-case basis. Box 3.1 summarizes the various stages involved in settling disputes.

Although virtually all disputes go through some or all of the stages laid out in Box 3.1, the DSU also provides for the option of binding arbitration (Article 25 DSU). This requires mutual agreement by the parties and is binding—no appeal is possible to the AB. However, in case of noncompliance with the outcome of the arbitration, the parties may ask for a compliance panel to be established and/or

request authorization to retaliate. As of 2008, Article 25 had been invoked only once, in a copyright dispute brought by the EU against the US (see Chapter 8).

Why the strengthening and legalization of the DS system if it worked pretty well? One reason was the use of Section 301 and its variants by the US (Bhagwati and Irwin, 1987). The US insisted that a quid pro quo for agreeing to Article 23 DSU-type disciplines was a strong DSU with more teeth.

3.3. Operation of the System

Many considered that the strengthening of GATT dispute settlement procedures was one of the major results of the Uruguay Round—especially for developing countries. The expectation was that small players would have greater incentives to bring cases (Schott and Buurman, 1994; Croome, 1999). The experience appears to support the optimistic expectations. Over 160 requests for consultations were brought to the WTO in its first five years of operation; three times more on a per annum basis than under the GATT. In the first ten years of the WTO more cases were brought than during the 46 GATT years. Developing countries are more often involved than in the past—acting as a complainant in 33 per cent of all cases and targeted as a respondent in 27 per cent of all cases through end 2006. Developing countries have successfully contested actions by large players (examples included some of the first cases brought to the WTO: a Costa Rican claim against US restrictions on cotton textiles and a case brought by Venezuela and Brazil contesting US gasoline regulations). Developing countries also increasingly contest each other's policies. Disputes between developing countries giving rise to requests for consultations and panels span all regions. Examples have included Brazil–Philippines (desiccated coconut); Guatemala–Mexico (antidumping actions on cement), India–Turkey (textiles), Indonesia–Argentina (safeguards for footwear), India–South Africa (antidumping duties on pharmaceuticals), Colombia–Nicaragua (import charges), Costa Rica–Trinidad and Tobago (antidumping on spaghetti), and Thailand–Turkey (textiles). However, LDCs have made very limited use of DS procedures. As of end 2008, only one LDC has initiated a case (Bangladesh against India—an antidumping dispute that resulted in a MAS in favour of Bangladesh).[1] No LDCs have been involved as a respondent.

[1] This case is discussed in Taslim (2006), who describes the strategy pursued by the Bangladeshi producer of batteries who was affected by Indian antidumping. Taslim argues that assistance by the Advisory Centre on WTO Law (discussed below) was important in documenting that India was most likely violating WTO rules and that the decision to bring the matter to the WTO was a key factor in inducing the Indian government to withdraw the measure.