

# Developing Countries and “Cross-Retaliation” in the WTO

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MARK PHOON, AUG 28 2013

### Why Do Developing Countries Not Systematically Use “Cross-Retaliation” To Secure Compliance With Favourable WTO Rulings?

#### Introduction

In 1995, the Uruguay Round of multilateral trade negotiations in the new World Trade Organization (WTO) established an enhanced dispute settlement mechanism (DSM). Known formally as the Understanding on Rules and Procedures Governing the Settlement of Disputes,<sup>[1]</sup> it was anticipated that this body of international law would result in quicker, fairer and more definitive resolutions of trade than under the law of the original General Agreement on Tariffs and Trade (GATT). Despite this, the possibility remains that a WTO member found to have WTO-inconsistent policies may still choose not to reform those policies to a satisfactory level. If the losing party fails to bring its measure into conformity within a reasonable period of time, the complaining party is entitled to compensation. Furthermore, should an agreement on compensation not be forthcoming there is a provision, in Article 22 of the Dispute Settlement Understanding (DSU), for the complainant to retaliate against the respondent (Anderson 2002).

Retaliation, however, has to satisfy several requirements. One of these requirements is that it should be imposed in the *same* sector as that in which the violation was found. There are occasions, however, in which the complainant may request the authorisation to retaliate in the other sectors or agreements (cross-retaliation) if the complainant considers it impracticable or ineffective to retaliate in the same sector. Retaliation, in this instance, applies on a discriminatory basis against the member country that fails to implement the recommendations or rulings. It is applied selectively by one member country against another (on a bilateral basis) and requires the Dispute Settlement Board's (DSB) approval.

In recent times, developing countries have become increasingly successful in using this settlement system against developed countries. At the same time, however, developing countries have had little effect in *forcing* the developed countries to actually implement these adverse rulings; their threat of retaliation simply does not have enough weight to induce action. One of the main reasons for this is the lack of economic power and size of developing countries and their markets, which make the effect of a tariff increase on imports, for example, of little consequence to developed countries. How then, can developing countries best achieve compliance vis-à-vis developed countries when WTO rulings are in their favour?

One possible option, which is the focus of this paper, is for developing countries to *cross-retaliate*.<sup>[2]</sup> One example would be cross-retaliation via the trade-related intellectual property rights (TRIPS) agreement. In this instance, the complainant member country would have the right to suspend concessions in the field of trade-related intellectual property rights to redress an injury suffered with respect to trade in goods or services. According to Basso and Beas (p19, 2005),

“The great advantage of retaliating through TRIPS is that it is straightforward, effective and legal. Furthermore, it may even lead to ‘socially acceptable’ (or desirable) consequences. Instead of transferring the burden of the litigation onto

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society, which would happen if tariffs were doubled for imports from the non-implementing party, the burden is transformed into a social benefit, for example through increasing access to medicines, cultural goods, entertainment products or just information.”

Given such compelling rationales, why then do we not see developing countries systematically use cross-retaliation against developed countries?

The purpose of this paper is to investigate the above-mentioned question. We seek to explore and analyse the reasons why developing countries do not systematically use cross-retaliation to secure compliance with favourable WTO rulings. As we view cross-retaliation as a subset of retaliation, we break down the discussion and first ask the question: is retaliation *per se* an effective instrument? We then go on to analyse the effectiveness of cross-retaliation. We argue that developing countries do not systematically cross-retaliate against developed countries for two main reasons. Firstly, the economic incentives from cross-retaliation do not marginally benefit developing countries and secondly, the preceding cases have not been successful models for developing countries to follow.

The remaining sections of the paper are organised as follows. In Section 2 we review the relevant literature and data on trade disputes and settlements within the WTO. In Section 3 we provide an analysis on the effectiveness of retaliation *per se*. Section 4 provides a theoretical explanation for the lack of systematic use of cross-retaliation by developing countries to secure compliance with favourable WTO rulings. Section 5 concludes.

## Section 2: Dispute Settlements in the WTO

Since the Uruguay Round, developing countries have had an increase in the rate at which they were initiating disputes under the DSU signalling an increased level of participation in the multinational organisation (Petersmann 1997). Poorer complainants have also filed and won concessions from large developed states in a wide variety of disputes. Three prominent cases of interest over the past decade have been that of India v. US (Wool shirts), Costa Rica v. US (Underwear), and Brazil v. European Communities (Poultry) (Busch and Reinhardt 2004). These recent cases provide some evidence that developing countries have access to recourse and that the dispute settlement framework within the WTO is, *prima facie*, fair and equitable.

There has also been evidence, however, that suggests that developing countries have a disadvantages or biased position in the dispute settlement system of the WTO. This disadvantage presents itself in two levels; 1) Access<sup>[3]</sup> and 2) Enforcement. In terms of access, developing countries are deprived of the ability to elevate dispute cases to the WTO's settlement mechanism for a number of reasons such as the inadequate coordination between the government and private sector, lower value of exports, or simply the lack of the necessary legal resources (see Breuss 2001 and Plasai 2007). In relation to enforcement, economists have conjectured that compliance with WTO rulings is still dependent on 'power' relationships. This is due to the fact that the agreements are self-enforcing and the threat of bilateral retaliation, which ironically often leaves the developing country complainants marginally worse-off, is the primary means of compensation in dispute settlement negotiations (see, for example, Maggi 1999 and Brown 2004).

In addition, data collected by Horn et al. (p1, 1999) show that developed countries have by far been the most active users of the dispute settlement system, with the G4 countries (Canada, EC, Japan and US) accounting for over 60 percent of all complaints. Furthermore, 75 percent of the members have not used the system at all since its inception, with the majority of them being developing and least developed countries. In light of the mixed evidence, how 'successful' have developing countries been in utilising the dispute settlement mechanism of the WTO?

According to the data presented by the WTO, as of April 2012, there have been 436 WTO complaints or consultation requests made to the Dispute Settlement Understanding (DSU), including 142 cases 'in consultation'.<sup>[4]</sup> Of these, there have been only six cases of 'compliance proceedings completed with findings of non-compliance'. The numbers indicate that the respondent WTO-members mostly comply with the recommendations and rulings of the DSB. In essence, WTO compliance has a good record.<sup>[5]</sup> Furthermore, the authorisation to retaliate has only been requested in six cases and granted in four.

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Table 1 below presents the findings of trade disputes in the WTO.

**Table 1: Trade Disputes in the WTO from 1995-2012**

	Developing Countries as Complainants	Developed Countries as Complainants	Developing Countries as Respondents	Developed Countries as Respondents	Total Cases
Disputes in WTO					436
Compliance proceedings completed without finding of non-compliance					4
					1
					1
					1
					2
Compliance proceedings completed with finding(s) of non-compliance					8
					2
					2
					4
					6
Authorization to retaliate requested (including 22.6 arbitration)					2
					4
					0
					6

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	6
Authorization to retaliate granted	
	8
	5
	0
	4
	4
Settled or terminated	
	31
	60
	45
	40
	88

Source: World Trade Organization 2013a, 2013b

This is an interesting finding in itself as the figures show that non-compliance in the WTO is significantly low in contrast to popular commentary. The data reveals two possible insights for the reasons why developing countries do not systematically use cross-retaliation to secure compliance with favourable WTO rulings. Firstly, the low-level of non-compliance renders the act of retaliation void and secondly, the relatively high percentage of disputes that are settled prior to the adoption of Appellate Body or panel reports. Around 21 percent of the dispute cases have been settled or terminated before adjudication suggesting that the incentives for prior settlement of disputes are marginally higher than proceeding with a panel ruling.

In addition, the data seems to indicate that securing compliance is more of a problem for developing countries than developed states. Findings of non-compliance have occurred more frequently when developing countries are complainants and developed countries the respondents. We seek to further explore the reasons and incentives for these results in the following section.

## Section 3: Is Retaliation *Per Se* an Effective Instrument

This section seeks to establish the benefits and costs of retaliation for developing countries. As we consider cross-retaliation to be a subset of retaliation, we first ask the question: Is retaliation *per se* an effective instrument for developing countries to use to secure compliance with developed countries. We also explore the alternative options, compensation and the ‘threat’ of retaliation, which developing countries can pursue. The next section then looks at the effectiveness of cross-retaliation.

The effectiveness of retaliatory action is, essentially, to change the incentives (incentive structure) of the actors involved such that their preferences are altered. When the incentives change, the actions taken by rational agents/states tend to follow. This will depend, fundamentally, on two features. Firstly, the incentives have to change by large enough amounts such that it alters the violating country’s behaviour.<sup>[6]</sup> Secondly, the marginal effect of such

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action should be positive for the complainant country. Only when these two conditions are satisfied is retaliatory action deemed an effective instrument for developing countries to secure compliance.

The debate on trade retaliation as an effective instrument of compliance has been ongoing and, as yet, no consensus amongst scholars has been reached. Some scholars have argued that retaliation in this manner has significant flaws. It offers no relief to the aggrieved member countries and their domestic consumers and firms. In addition, retaliation may also result in market distortions and welfare losses. This goes against the spirit and philosophy of the WTO and punishes consumers in the complainant state and exporters in the violator state. This may in turn result in, or act as a catalyst for, political resentment and upheaval within the country (see Bronckers and van den Broek 2005). In essence, trade retaliation allows member countries to fight protectionism with protectionism which may lead to a ‘race to the bottom’ in socio-economic terms. This will have negative aggregate effects and therefore does not satisfy the necessary conditions to qualify as an effective instrument for developing countries.

On the other hand, the perceived ineffectiveness of trade retaliation as an effective instrument in the toolkit of developing countries needs to be re-looked given the current international trading context. Subramaniam and Watal (2003), for example, argue that the quantitative restrictions imposed on textiles and clothing products by developed countries will not be eliminated early in the next millennium, as required by the Uruguay Round Agreement on Textiles and Clothing (ATC). This provides developing countries with more policy space and effectiveness, albeit in the short-term, to retaliate under trade agreements. Furthermore, Brown (p3, 2004) provides evidence to empirically confirm the prior speculation that developing country plaintiffs have had *more* economic success in resolving trade disputes.

## *The Alternative Models*

There is also the question of whether compensation is more viable economically to developing countries than retaliation. Compensation under the WTO rulings comes in the form of reforms. This could be in the form of a temporary lowering of import barriers or some other changes consistent with existing agreements but must be offered on a most-favoured-nation (MFN) basis (Anderson 2002). Compensation in this form is equivalent to trade liberalisation and standard economic theory tells us that this can be welfare enhancing (see, for example, Dornbusch 1992). Although some scholars have argued that compensation is rarely preferred to retaliation for a number of reasons, we conjecture that this might be one reason as to why developing countries do not use retaliation (and cross-retaliation) to secure compliance with developed countries.

Another possible model that seeks to explain the low levels of retaliation and consequently the relatively high levels of compliance is the threat of retaliation.<sup>(7)</sup> This line of reasoning suggests that the threat of retaliation influences the incentives in a dispute, that is, it alters the preferences and hence the behaviour of the parties involved. It should be noted that these incentives are not necessarily monetary. The reason why developed countries comply when a threat of retaliation is issued is due to the fact that these countries worry about the normative condemnation in a legal defeat rather than effects of direct retaliation *per se*. In other words, the negative connotation of being a ‘non-compliant’ member damages the reputation of the violating country which, in a repeated game-theoretic framework, can have detrimental consequences.

On balance, we posit that the empirical data is suggestive of the view that retaliation *per se* is not an effective instrument for developing countries to use to secure compliance with favourable WTO rulings. The next section explores the effectiveness of cross-retaliation.

## **Section 4: Cross-Retaliation as an Option: Discussion**

Given the preceding debate, one option that has risen to the fore in the academic literature is the use of cross-retaliation (mainly via TRIPS). Astute scholars have observed that the power asymmetries between developing and developed countries reside in developing countries not having serious international obligations in the first place. The threat of a tariff increase does not have much potency when a country has no WTO obligations or when such a large difference between bound and applied tariffs devalues such an action (Subramaniam and Watal 2003). As such,

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retaliation under the General Agreement on Trade in Services (GATS) would be ineffective.

On the other hand, developing countries have undertaken serious commitments on TRIPS particularly in the pharmaceutical, biotechnological, information technology, and software sectors. Hence, an argument can be made for the use of cross-retaliation. Theoretically, the rationale for such cross-retaliation appears sound: developed WTO-member countries are not likely to be affected by a suspension of trade concessions in goods or services by developing WTO-member countries which are less economically powerful. Is TRIPS then a feasible option for developing countries? While, theoretically, an elegant argument, the data has shown otherwise which we argue are for the following reasons.

We argue, as mentioned in the earlier section, that there are two main reasons why developing countries do not systematically use cross-retaliation to secure compliance with favourable WTO rulings. Firstly, the economic incentives from retaliation (and cross-retaliation) do not marginally benefit developing countries. Rational actors/states weigh the marginal benefits and marginal costs from cross-retaliation, and will only choose to cross-retaliate if it is marginally beneficial for them. The low percentage of non-compliance cases and the relatively high percentage of ‘settled or terminated’ cases within the WTO indicate that cross-retaliation is not in their interests.<sup>[8]</sup> We also argue that accurately measuring the economic benefits/costs of the effect of changes to intellectual property rights on the national economy is highly complex.<sup>[9]</sup> This is a potential roadblock for the use of cross-retaliation as the effectiveness of retaliatory action is also a function of time.<sup>[10]</sup> The longer it takes to alter incentives and change preferences, the less effective retaliatory action will be.

Secondly, the preceding cases, all of two complete cases, have not been successful models for developing countries to follow. WTO arbitrators have so far approved TRIPS cross-retaliation on two occasions; in favour of Ecuador (against the EC) and most recently in favour of Antigua (against the United States).[11]

The seminal case of cross-retaliation in north-south relations was between Ecuador and the European Commission (EC) in relation to the EC’s banana trading regime. In this case, Ecuador requested authorisation pursuant to Article 22.2 of the DSU to suspend concessions or other obligations under the TRIPS Agreement, GATT and GATS, with respect to findings of inconsistencies regarding the EC’s banana regime under the GATT and GATS.[12] The arbitrators found that Ecuador could request and obtain authorisation to retaliate on the ‘consumer goods’ category. Ecuador could also request and obtain authorisation to retaliate under the GATS with respect to ‘wholesale trade services’. Furthermore, Ecuador could request and obtain authority to retaliate under the TRIPS Agreement with respect to copyrights and related rights, geographical indications, and industrial designs.[13] In spite of the authorisation, Ecuador, however, did not in fact suspend any agreements. This could be for a number of reasons, as we have stated in earlier section that enforcement/compliance is a function of several factors.

In the case of Antigua, the Antiguan authorities managed to secure an arbitral ruling allowing the use of cross-retaliation against the United States. Antigua requested and was granted authorisation to suspend its obligations under the TRIPS Agreement. Despite the right to cross-retaliate however, it is still uncertain if Antigua will indeed implement a suspension of intellectual property rights against the US. Such models of uncertainty puts into question the effectiveness and efficiency of actually *implementing* cross-retaliation. Given the evidence above, we conjecture that cross-retaliation, *on its own*, is not an effective instrument.

In light of the evidence presented above, we view the effect of cross-retaliation as a poor instrument for developing countries to secure compliance and as a result have only been requested on very few occasions. Even if cross-retaliation or the threat thereof can be effective as an enforcement mechanism, it is only one of several factors that may contribute to induce compliance. In addition, we posit that perhaps the most effective retaliation is for rational agents (states) to target voters at the margin. Economically, this tends to be groups involved within the GATS as opposed to TRIPS or TRIMS. Politically, however, these groups lie within the intellectual property realm. The relative power between the competing groups could have significant policy implications. This is an interesting avenue for future research.

## Section 5: Concluding Remarks

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The Uruguay Round of multilateral trade negotiations in the new WTO established an enhanced dispute settlement mechanism which was anticipated to provide fairer and more definitive resolutions of trade than under GATT. In spite of this framework, developing countries are still susceptible to power asymmetries as developed countries do not necessarily have to comply with the decisions of the WTO dispute board. One possible way of overcoming this compliance issue is through cross-retaliation. Empirical data, however, has shown that there have only been two cases of cross-retaliation.

The purpose of this paper was to analyse the reasons why developing countries do not systematically use “cross-retaliation” to secure compliance with favourable WTO rulings. We first discussed the current literature and available data on the issue. As we view cross-retaliation as a subset of retaliation, we then break down the discussion and ask the question: is retaliation *per se* effective? We then go on to analyse the effectiveness of cross-retaliation.

We argue that developing countries do not systematically cross-retaliate against developed countries for two main reasons. Firstly, the economic incentives from cross-retaliation do not marginally benefit developing countries and secondly, the preceding cases have not been successful models for developing countries to follow. In addition, we posit that perhaps the most effective retaliation is for rational agents (states) to target voters at the margin. Economically, this tends to be groups involved within the GATS as opposed to TRIPS or TRIMS. Politically, however, these groups lie within the intellectual property realm. The relative power between the competing groups could have significant policy implications. This is an interesting avenue for future research.

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[1] See Annex 2 of WTO Agreement: Understanding on rules and procedures governing the settlement of disputes.

[2] We define cross-retaliation here as the suspension of concessions in a sector of trade different than the sector in which the trade injury is suffered, including under a different WTO covered agreement (see Abbott 2009).

[3] We define access as having the ability (resources, information, etc.) to bring a case to the DSB.

[4] ‘In consultation’ refers to the process where the complainant requests consultations with the respondent with no dispute panel established. According to the WTO, a majority of disputes do not proceed beyond consultations indicating that consultations are often an effective means of dispute resolution in the WTO.

[5] Ibid.

[6] Such incentives consist of a myriad of variables such as prices, time taken to effect change etc.

[7] See, for example, Busch and Reinhardt (2004).

[8] Refer to Table 1 for the above mentioned statistics.

[9] Abbott (2004), however, argues that establishing the value of TRIPS cross-retaliation is not an obstacle to building a successful cross-retaliation programme as the valuation of “IP assets” (and the economic effect of withdrawing IP protection) is evaluated by business analyst routinely and in fairly precise ways.

[10] See discussion in Section 3.

[11] There is a third case of cross-retaliation involving the countries of Brazil and the United States. This request, however, is presently suspended by agreement of the parties to the dispute.

[12] See WTO dispute settlement DS27.

[13] See Eduardo and Spadano (2008) for a comprehensive discussion on the case.

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