

# Introduction

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## 1 The Project

This is the second in the series of Reporters' Studies emanating from the American Law Institute (ALI) project *Principles of Trade Law: The World Trade Organization* (WTO). The aim of the project is to provide systematic analysis of WTO law based in both Economics and Law. Such an interdisciplinary approach is in our view necessitated by the fact that the WTO Agreement has inherently economic objectives, which is not to deny that it may have other objectives as well. A thorough analysis of the appropriate design of trade law therefore inevitably has to take into account how well the interpretation of the law affects the achievement of this purpose. The law can therefore not be interpreted from a strictly legal perspective only.

A fundamental methodological problem facing the project is the lack of a “manual” for how to perform a joint economic and legal analysis of the WTO contract; there is no field “The Economics of Trade Law” that can be relied upon for the purpose of the project. The relevant specialized fields, such as International Trade Law and International Economics, instead differ widely, both in terms of aims and in terms of method, and lawyers and economists are typically too specialized in their respective fields to be able to undertake a legal-*cum*-economic analysis of the law by themselves. Instead, such an analysis requires the joint efforts of economists and lawyers. The main idea behind this project is to develop such collaboration.

The project undertakes yearly analysis of the case law from the adjudicating bodies of the WTO. The intention is each year to analyze all disputes that in the previous year came to an administrative end, either because they were not appealed or because they went through both the panel and the Appellate Body (AB) stages, even though time constraints may prevent us from covering each and every dispute that falls into this category. Each dispute is evaluated jointly by an economist and a lawyer. The general task is to evaluate whether the

ruling “makes sense” from an economic as well as legal point of view, and if not, whether the problem lies in the legal text or in the interpretation thereof. The teams of lawyers and economists will not always cover all issues discussed in a case; they will however seek to discuss both the procedural and the substantive issues that form the “core” of the dispute.

The Reporters’ Studies are initially scrutinized in a meeting of all of the Reporters. After revisions resulting from that meeting, the Studies are next presented and discussed in a meeting with an external advisory group, comprising both lawyers and economists. The final versions, such as those published in this volume, have been subjected to still another round of revisions derived from the advisory meeting. But despite these collective efforts, each pair of authors remains solely responsible for the Studies it has authored.

It is intended that this first phase of the project will serve two purposes. First, given the central role of the Dispute Settlement system in the WTO (and the lack of accountability of its adjudicating bodies seen by some observers), it is of vital importance that the system is constantly and carefully scrutinized. Our yearly independent analysis of the emerging case law will, it is hoped, contribute toward this end.

The other purpose of the first phase of the project is to serve as a steppingstone toward an analysis of the core provisions of the WTO contract itself. Depending on the progress made over the next few years and our views on the quality of the primary and secondary WTO law, we hope that our work will eventually take the form of an articulated set of Principles of WTO Law.

In this second year the project focused on the case law of the year 2002. The Reporters’ Studies have been drafted by the following persons, who have been appointed Reporters for the project by the ALI:

*Kyle Bagnwell*, Kevin J. Lancaster Professor of Economics, Columbia University, USA.

*Gene M. Grossman*, Jacob Viner Professor of International Economics, Princeton University, USA.

*Henrik Horn*, Professor of International Economics, Institute for International Economic Studies, Stockholm University, Sweden.

*Robert L. Howse*, Alene and Allan F. Smith Professor of Law, University of Michigan Law School, USA.

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*Damien J. Neven*, Professor of Economics, Graduate Institute for International Studies, University of Geneva, Switzerland.

*Alan O. Sykes*, Frank and Bernice Greenberg Professor of Law, University of Chicago Law School, USA.

*Joseph H.H. Weiler*, Joseph Straus Professor of Law and Jean Monnet Chair, New York University School of Law, USA.

The Reporters' Studies in the volume have benefited from very helpful discussions with the following participants in an advisory invitational conference, consisting of lawyers, both practicing and academic, and economists, on February 5 and 6, 2004, in Philadelphia.

*José E. Alvarez*, Columbia University Law School, New York, NY, USA.

*Richard E. Baldwin*, Department of Economics, Graduate Institute of International Studies, Geneva, Switzerland.

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*Diane P. Wood*, U.S. Court of Appeals, 7th Circuit, Chicago, IL, USA.

*Claire Wright*, Thomas Jefferson School of Law, San Diego, CA, USA.

Before turning to the Reporters' Studies, we note that this project would not have been possible without the help and support of many individuals and institutions. We would in particular like to express our gratitude to The American Law Institute. Its director, Professor Lance Liebman, has been extremely helpful in taking the project to where it is today. We have also benefited greatly from the support of Michael Traynor, the President of the ALI, as well as from the very efficient administrative aid provided by Elena Cappella and Michael Greenwald, Deputy Directors of the ALI, as well as by other ALI staff members. We are also extremely grateful for financial support from the Jan Wallander's and Tom Hedelius'

Research Foundation, Svenska Handelsbanken, Stockholm, as well as from the Asia-Pacific Economic Cooperation Center at Columbia University and the Milton and Miriam Handler Foundation.

## **2 The Reporters' Studies on the WTO Case Law of 2002**

We briefly summarize the Studies in the order of their appearance in this volume.

Bagwell and Mavroidis, discussing *US - Section 129*, essentially agree with the outcome reached by the Panel. In this case Canada challenged the legality of the US retroactive system for antidumping and countervailing duty collection, without raising the general question of the time-function of remedies in the WTO system. In the authors' view the Panel rightly dismissed the challenge of Canada. Bagwell and Mavroidis do, however, question the allocation of burden of proof by the Panel, arguing that it imposed an unreasonably high burden by requiring Canada to demonstrate not only that the US legislation in question did not cover the subject matter of the dispute but also that there was no other piece of US legislation dealing with the issue either. The authors also criticize the drafting of the Panel's report, noting a discrepancy between the formulation of Canada's claims in the factual part and that in the legal findings section of the report.

The *US - FSC* arbitral award is examined by Howse and Neven. The EC won the original case, arguing that the United States FSC statute amounts to an export subsidy. Faced with subsequent noncompliance by the United States, the EC then requested authorization from the WTO to impose countermeasures. The Arbitrators authorized the EC to do so up to the value of the total subsidy by the United States (an amount in the neighborhood of 4 billion dollars), the single highest retaliation ever authorized by a GATT/WTO panel. Howse and Neven question the consistency of the recommended remedy with the applicable law and also highlight the resulting impracticalities in the event of sequential legal challenges against the FSC. In the economic analysis of their Study, borrowing from the property rather than the liability rule, the authors argue that a property rule approach to countermeasures does not sit comfortably with established principles of international law. But the paper also highlights an attraction of such an approach, that it may allow for efficient breach even when

there is a large number of parties. The implementation of a property rule approach to countermeasures may still be difficult in practice. For instance, the distribution of rents among victims may raise some difficult issues.

Grossman and Mavroidis discuss the AB report on *US - Corrosion-Resistant German Steel*. In this case, the question before the AB was to what extent the *de minimis* thresholds that were explicitly stated and applied in the context of an original countervailing investigation are also legally relevant in the context of a sunset review where no such explicit reference is made. The authors concur with the AB findings about the nonapplicability of *de minimis* thresholds in such situations and develop additional arguments to support its ruling. They also concur with the AB findings on evidentiary standards during reviews. Both of their conclusions are predicated on their understanding of the function of, or the objectives pursued by, the *SCM Agreement* as currently drafted. They do however, point to two unsatisfactory aspects of the wording of Article 21.3 of the *SCM Agreement*: the level of permissible countervailing duties when the level of subsidization changes over time is unclear, as are the evidentiary standards that might lead to noncontinuation of countervailing duties in a situation in which the originally injured domestic industry no longer has an interest in the matter.

The *US - Non-Recurring Subsidies* dispute, analysed by Grossman and Mavroidis, deals with an issue the authors dealt with in the previous volume: to what extent non-recurring subsidies are exhausted if subsidized assets are sold through arm's length transactions. Although the AB has now substantially deviated from its earlier decision by accepting that arm's length operations do not necessarily exhaust the effect of subsidies previously paid, the AB still falls short of establishing a reasonable standard to be applied in all similar future cases. The reason for the continuing disagreement of the authors with the AB, the change in case law notwithstanding, is the AB's failure to understand the economic concept of a sunk cost, insisting instead that the sales price at which a privatization takes place is relevant to the determination of a continuing benefit from a subsidy. The United States was correct, in the AB's view, when it argued that the price at which a profit-maximizing enterprise acquires an asset will not affect its subsequent production and pricing decisions. That such an enterprise will wish to "recoup a market return on its investment" is simply irrelevant to its subsequent business decisions.

Howse and Neven reflect on the report on *Canada - Aircraft*, a longstanding litigation between Canada and Brazil over subsidization of sales of commuter jets by both countries. The Panel dealt with Brazil's specific challenges to certain transactions in which federal and provincial entities provided financing assistance in connection with the sale of Bombardier aircraft. In the view of the authors, for the most part the panel applied existing jurisprudence dealing with export subsidies to the factual record. In particular, they single out the panel's application of a "private investor principle," and question whether the conditions under which subsidies that were granted by the export development and industrial policy agencies were more favorable than the conditions that were available from alternative private sources. However, they find it impossible to evaluate the panel's comparison between the conditions available in the market and those granted by the agencies, since vital factual information concerning the transactions in question has been removed from the panel report for reasons of commercial confidentiality. It is striking, they note, that the Panel paid significant attention to the distinction between programs that leave some discretion to the authorities to grant possibly unlawful subsidies and programs that instruct the authorities to do so. The authors thus question the effectiveness of a legal framework that imposes on an institution behavioral norms that contradict its "raison d'être." In their view, this raises the broader question of whether the constraints imposed by the SCM agreement are reasonable, and the authors here make extensive references to the economic literature supporting the use of subsidies under specific circumstances.

In their analysis of the AB's determination in the *US - Line Pipe* dispute, Grossman and Mavroidis argue that the text of the *Agreement on Safeguards* (SGA) suffers from two serious deficiencies: First, Article 4.2b of the SGA calls for a causality test that is economically incoherent, since imports cannot be a cause of injury inasmuch as they are endogenously determined along with the domestic injury. The causality test for a safeguard measure can therefore never be met, and it is consequently not operational. Second, the Agreement fails to make explicit the objectives of the safeguard provisions. With an incoherent text and an absence of clear objectives, it is impossible for the adjudicator to determine when the conditions for a safeguard measure have been satisfied and what is the permissible extent of such a measure. In the *Line Pipe* dispute, Korea claimed that the US had not properly

attributed injury to its various causes and that its safeguard measures exceeded in scope what is permitted under the treaty. The AB ruled against the United States essentially on procedural grounds. Grossman and Mavroidis find it difficult to disagree with the AB ruling in view of the causality analysis contained in the USITC investigatory report. However, when the AB embraced the non-attribution requirement in Article 4.2b of the SGA, it lent operational significance to an incoherent requirement. Grossman and Mavroidis thus find the AB ruling flawed in this respect. The AB could instead have ruled that the legal text lacks an internally consistent interpretation and could therefore have refrained from ruling in the particular dispute, instead calling for the WTO Members to address the shortcomings of the text through legislative action. Alternatively, the AB could have interpreted the text imaginatively so as to render it internally consistent and operational. The authors recommend that the latter approach should have been taken, albeit in a cautious manner.

Bagwell and Sykes also discuss the AB report on *Chile - Price Band*. In this case, Argentina challenged the legality of a Chilean regime for determining import prices. The dispute also involved safeguard measures, but the Panel ruling on these was not appealed and the authors concentrate instead on the price band issue. They conclude that both from an economic and from a legal perspective, the case could have gone either way. Economically, in order to determine its effects, the authors argue, one would have to wait and see what would be the level of duties that Chile would choose to apply to the goods in question once it had done away with the Price Band system. In their view, the system as it has operated has had some trade-liberalizing features, since Chile *de facto* has not always applied the maximum MFN rate as it was entitled to do under the WTO. Legally, the authors see good arguments to support Chile's practice ever since it amended the original Price Band system and started applying it in a manner that ensured that the MFN duty "ceiling" would not be exceeded. On the other hand, they also see merit in the Argentine claim that due to the convoluted "esoteric" calculations that led to the final imposition, trading partners had no *ex ante* certainty as to the transaction costs for exports to the Chilean market.

Bagwell and Sykes discuss the Panel report on *India - Auto*. In this case, India was called to defend two of its programs, the so-called "indigenization" and "trade balancing" requirements. India's practices were challenged as running afoul of provisions of the WTO

*Agreement on Trade-Related Investment Measures* (TRIMs), among other legal provisions, in practices constituting local content requirements. While the authors believe the case does touch on broader legal issues of systemic importance, they consider that it breaks little new ground in any of these matters. The authors agree with the legal reasoning of the Panel. The indigenization requirements and trade balancing requirements are clear violations of GATT 1994 and TRIMs in the absence of a valid defense. India's purported justification for them -- a balance of payments justification under Article XVIII of GATT 1994 -- had been found insufficient in the earlier proceeding regarding its import licensing system. Viewed from a general economic perspective, the contested types of schemes, which essentially involve a local content requirement, may be attractive to an importing country government when market power is present. The authors suggest that the conditions in place in *India Auto* may indeed have been such as to make the contested scheme desirable from an Indian point of view, shifting profit from foreign automobile manufacturers to domestic input suppliers. However, there are strong reasons to suggest that local content requirements are harmful to trading partners, and the authors therefore conclude that the WTO rules that restrict the application of these schemes rest on a firm economic foundation.

Howse and Neven discuss the *US - Havana Club* report. At issue was a requirement of US law imposed on foreigners in the area of intellectual property protection. In the dispute, the Appellate Body reversed the Panel's findings. In the AB's view, the *Havana Club* legislation constituted a hurdle to the recognition of trademark rights that was imposed on some foreign nationals, but not on US nationals. The AB did recognize that there were serious obstacles faced also by US nationals in a given situation, but there still remained a hypothetical possibility that these might be overcome in a given case, resulting in better treatment of US nationals due to the *Havana Club* legislation. The AB ruling is, in the authors' eyes, a relatively straightforward application of the spirit and letter of the GATT *Section 337* panel ruling. With respect to original owners of trademarks attempting to assert their rights in the United States, the AB found that if there were "two separate owners who acquired rights, either at common law or based on registration, in two separate United States trademarks before the Cuban confiscation occurred" and these trademarks were the same or similar to a Cuban trademark used in connection with a business that was confiscated, and

the one owner was American and the other Cuban, only the Cuban national would be affected by the regime in the *Havana Club* legislation.

Horn and Mavroidis examine the *US - Lumber* dispute concerning the preliminary determination of countervailing duties by the United States on the importation of Canadian softwood lumber. The authors concentrate on whether the United States had adequately showed that Canadian stumpage programs--the contracts between the government and private harvesters of standing timber--subsidize downstream lumber producers, and that CVDs therefore were justified. Horn and Mavroidis find serious problems with the benchmarks proposed in the dispute. First, the private sector, no-subsidy benchmark imposed by the *SCM Agreement* does not take into consideration whether a divergence between this benchmark and actual government policy reflects the pursuit of legitimate government policies. Second, and in contrast to the views of the adjudicating bodies, Horn and Mavroidis largely agree with the United States in interpreting the private sector benchmark as referring to prices in the domestic market when domestic prices are significantly affected by subsidization. Third, Horn and Mavroidis also see severe practical difficulties in using a foreign sector benchmark, as proposed by the United States, and like the adjudicating bodies they believe that the United States did not adequately prove the existence of subsidization. Their general conclusion is that this may in fact be impossible in cases involving such widespread and complex interventions as those at stake in *US - Lumber*.

In the final Study, Horn and Weiler discuss the *EC - Sardines* dispute. The dispute is noteworthy in that it is the first dispute in which a Technical Barriers to Trade (TBT) issue was fully discussed. The dispute centers on the role that international standards are called to play in the TBT system, and the institutional possibilities for Members to deviate from these standards. Horn and Weiler focus on two related aspects of the AB report. The first is the method of interpretation, exemplified in this decision with its rhetorical emphasis on "textual" interpretation, as opposed to a more contextual interpretation where the provisions of the TBT are evaluated in the light of its function in the WTO Agreement. The second theme is the question of how to allocate the burden of proof in the context of Art. 2.4 TBT. The Panel claimed it falls on the WTO Member that deviates from the international standard to establish that the standard at hand is inefficient and/or inappropriate to fulfill its

legitimate regulatory objectives. The AB instead put the burden on the complainant. But at the same time the AB stipulated an extremely low evidentiary requirement in order to discharge this burden. The consequence was to underscore the importance of international standards for the purpose of implementing the TBT, without discussing whether these standards have the necessary legitimacy, which the authors put into question. The authors conclude that it helps neither the legitimacy of the AB nor the legitimacy of the WTO as a whole to decide issues such as the relevance of consensus decision making, the cultural integrity of a language, or the presumptions on burden of proof, without any meaningful analysis or even indication of an awareness of the deeper policy issues and consequences that are at stake.

Similar to in the previous year's volume, we will here make a bold attempt at summarizing this year's Studies. We have thus classified the findings of each Study according to the extent to which it accepts the adjudicating body's reasoning, as well as the outcome of the dispute. Needless to say, this is not an exercise that can be done with any degree of precision. For instance, even if the rationale provided by an adjudicating body is classified as "unsatisfactory", this does not necessarily mean that the authors do not see any merit in it. This is our summary evaluation:

	<b>Rationale</b>	<b>Outcome</b>
<i>US - Section 129</i>	partly satisfactory	correct
<i>US – FSC</i>	partly satisfactory	correct
<i>US - Corrosion-Resistant Steel.</i>	satisfactory	correct
<i>US - Non-Recurring Subsidies</i>	unsatisfactory	correct
<i>Canada – Aircraft</i>	satisfactory	partly wrong
<i>US - Line Pipe</i>	unsatisfactory	correct
<i>Chile - Price Band</i>	satisfactory	correct
<i>India – Auto</i>	satisfactory	correct
<i>US - Havana Club</i>	partly satisfactory	partly wrong
<i>US – Lumber</i>	partly satisfactory	correct
<i>EC – Sardines</i>	unsatisfactory	correct

As can be seen, there is a high degree of acceptance of the outcomes in these disputes; only in three instances would the authors definitely preferred to have seen a completely different verdict. But at the same time the Reporters found methodological deficiencies in 7 out of 11 reviewed disputes, and in 3 of them the reasoning was directly unsatisfactory. This picture closely resembles the one found that emerged last year. We find this troubling, since we do not believe that disputes will normally yield desirable outcomes without a solid legal and economic basis.

