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*Renegotiation in Transatlantic Trade Disputes*

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## I. INTRODUCTION

A great number of theoretical and empirical studies have examined the performance of the World Trade Organization (WTO) dispute settlement (DS) since its introduction in 1995.<sup>1</sup> Although the mechanism generally seems to be useful for settling disputes, a number of problems have been identified. To begin with, it is doubtful that developing countries have equal opportunities to enforce their rights. Secondly, some rulings have been criticized for their sole emphasis on promoting trade liberalization, ignoring in particular environmental concerns. Thirdly, the exact nature of settlement and its economic impact is unknown in most cases and is possibly not in accordance with WTO agreements. Yet, the most important problems—and we will focus on them—are apparently those related to disputed implementation of Dispute Settlement Body (DSB) rulings. Although the Dispute Settlement Understanding (DSU) sets a timeframe and urges the losing defendant to comply, there have been numerous delays, conflicts about interpretation of the text, severe threats, and high-profile cases of outright non-compliance.

Such implementation problems have been particularly relevant for the relationship between the United States (US) and the European Communities (EC). Some transatlantic disputes have received enormous publicity in this regard, and they are not expected to be the last. In fact, the situation seems to be so critical that two conclusions play a prominent role among observers. The first one claims that we are undergoing a series of ‘trade wars’. This view is nurtured by aggressive speeches of politicians and the tendency to use the word ‘sanction’ when talking about the suspension of concessions authorized by the DSB. The

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<sup>1</sup> See Leitner & Lester, ‘WTO Dispute Settlement 1995–2002: A Statistical Analysis’ (2003) 6 *JIEL* 251; Büttler & Hauser, ‘The WTO Dispute Settlement System: A First Assessment from an Economic Perspective’ (2000) 16 *JLEO* 503; Hudec, ‘The New WTO Dispute Settlement Procedure: An Overview of the First Three Years’ (1999) 8 *Minnesota Journal of Global Trade* 1, and the contribution by M.L. Busch & E. Reinhardt in this volume.

second one focuses on the specific role of the WTO in these conflicts and suggests that its credibility is severely at risk due to the alleged 'failure' of the DS in resolving them.

In what follows, we will question these conclusions. In our view, disputes are about renegotiation, not about war. Furthermore, even if there is no immediate compliance with a DSB ruling, the credibility of the WTO DS is not impaired, as long as its function is properly understood.

As reference point for our analysis, we offer in the following section a 'rule-oriented' perspective on disputes and non-compliance. The bottom line of this perspective is confronted in section III with an alternative view, which highlights the importance of flexibility through renegotiation in the face of incomplete contracting and 'local' lack of commitment. It will be shown that members of the WTO have had in mind to endow the agreements with a good portion of such flexibility when concluding them. Whereas section III is merely positive in nature, the fourth section adds some normative considerations about flexibility. Section V assesses three transatlantic disputes in light of the renegotiation perspective, and the last section concludes.

## II. A RULE-ORIENTED PERSPECTIVE

Analysts who complain about alleged failures of the WTO DS implicitly argue that the level of 'rule orientation' among members is too low and that the best way to cope with such problems is to strengthen the bindingness of rulings.<sup>2</sup>

For the purpose of our paper, we emphasize two distinct facets of rule orientation in an international trade agreement. The first facet is relevant whenever a member alleges that a breach of contract has occurred. Then, someone has to determine whether this allegation is true. Such adjudication does not only give a clue of what is 'right' or 'wrong'. It also influences the distribution of contract value. In this context, rule orientation would have to be contrasted with power orientation.<sup>3</sup> The latter predicts that adjudication results in a solution which reflects the difference in power of the countries. The more powerful country is expected to attain a more favourable outcome *ceteris paribus*. In contrast, the rule-oriented determination makes reference to rules and procedures previously agreed upon, is based on equality of countries, and would include impartial third-party arbitration. It is argued that such rule orientation has continuously gained support since the establishment of the GATT, notably due to a more and more legalistic DS process.

The second facet of rule orientation takes the determination of breach as given and deals with the nature of remedial action. In the WTO context, it is about

<sup>2</sup> This might be achieved, for example, by raising the authorized retaliation level in case of non-compliance.

<sup>3</sup> See J.H. Jackson, *The World Trading System: Law and Policy of International Economic Relations* (1997), at 109.

implementation of a DSB ruling, and therefore about the legal effect of an adopted panel (or Appellate Body) report. Under the rule-oriented perspective, such ruling creates an international legal obligation upon disputing parties to carry out the decisions of the DSB.<sup>4</sup> A losing defendant is consequently obliged to 'specific performance' as regards the adopted recommendations. John H. Jackson examines the DSU and finds at least 11 clauses that support such rule orientation.<sup>5</sup> An opposite view would be that the losing defendant has free choice between compliance with the ruling, offering of concessions in other areas, or acceptance of retaliation in the form of suspension of concessions. The second facet of rule orientation is accordingly not contrasted with power orientation, but with flexibility of implementation.

It is this second facet that stands at the forefront of discussion today. There is indeed a debate about the question of to what extent members of the WTO must be guided by rule orientation when implementing a DSB ruling.<sup>6</sup> This debate is of utmost importance, and from now on, we will implicitly have in mind this second facet whenever we talk about 'rule orientation'.

There is no doubt that, from a static perspective, such rule orientation contributes decisively to the security and transparency of the world trading framework. However, taking into consideration that agreements are concluded and maintained by governments, which form expectations about their future usefulness, the rigidity incorporated in the bindingness of DSB rulings becomes an element of concern. Admittedly, rule orientation might eventually be the *preferred* way to settle a dispute, and the DSU says in Article 22:1 that '... neither compensation nor the suspension of concessions or other obligations is preferred to full implementation of a recommendation to bring a measure into conformity with the covered agreements'. However, a preference *per definitionem* leaves room for alternative solutions. And it cannot be interpreted as an obligation to go ahead in a particular way.

### III. AN ALTERNATIVE PERSPECTIVE: FLEXIBILITY AND RENEGOTIATION

Flexibility, which is understood as the provision of renegotiation opportunities between multilateral rounds of liberalization, is essential for the success of

<sup>4</sup> See Jackson, 'Designing and Implementing Effective Dispute Settlement Procedures: WTO Dispute Settlement, Appraisal and Prospects' in A.O. Krueger (ed), *The WTO as an International Organization* (1998) 161, at 169.

<sup>5</sup> See Jackson, 'The WTO Dispute Settlement Understanding—Misunderstanding on the Nature of Legal Obligation' (1997) 91 *AJIL* 60, at footnote 11.

<sup>6</sup> Schwartz & Sykes, 'The Economic Structure of Renegotiation and Dispute Resolution in the WTO/GATT System' (2002) 31 *JLS* S179; Sykes, 'The Remedy for Breach of Obligations under the WTO Dispute Settlement Understanding: Damages or Specific Performance?' in M. Bronckers & R. Quick (eds), *New Directions in International Economic Law* (2000), 347; and Bello, 'The WTO Dispute Settlement Understanding: Less is More' (1996) 90 *AJIL* 416, are prominent sources which tend to reject the claim that there is a legal obligation to comply.

international trade agreements. It allows adaptation to a changing environment, and it is necessary whenever governments should be induced to make far reaching long-term concessions.

In fact, rule orientation does not necessarily preclude renegotiation. After having demonstrated the need for renegotiation from a government perspective, we will describe a number of 'conventional' instruments that can be used for such a purpose. These are consistent with rule orientation, since they are based on explicit provisions of the WTO agreements. However, these tools unduly restrict flexibility. The deficiency is removed if violation and non-compliance are admitted as implicit instruments for renegotiation.

### **A. Motivations for renegotiation**

There is an indefinite number of possible reasons why governments want to renegotiate an international trade agreement. We consider a broad concept of renegotiation here and use the term whenever a government deviates from a concession<sup>7</sup> between multilateral rounds of liberalization. This deviation provokes a response by affected trading partners, but it does not challenge the continuity of the agreement. Renegotiation is assumed to be about more protectionism, not about less. Using this definition, it should be stressed that such behaviour must entail costs for the initiating country. Otherwise, we would almost permanently be confronted with renegotiation. Benefits and costs of deviations have to be understood in terms of political economy. International trade agreements are concluded between governments, and each government chooses its trade policy by maximizing an individual objective function. The latter consists of a weighted sum of political contributions from lobby groups and some aggregate social welfare.<sup>8</sup> The structure of optimal protection is vulnerable to changes in different variables, such as the degree of political organization of lobby groups or the relative weight that the government attaches to political contributions compared to overall welfare. The general economic climate, the election cycle, or technological advance—to name just a few—can also have a substantial influence on the desired level of current protection. Such diversity of factors and the uncertainty characterizing their development make it impossible to write an international trade agreement that anticipates the future and makes all actions (or prohibitions) contingent on the evolution of these variables. From a government perspective, any agreement is therefore characterized by too much 'rigidity': the concessions are not made sufficiently dependent on the future state of the world. Rigidity is one of two distinct forms of incomplete contracting, the other one being 'discretion'.<sup>9</sup> Discretion is given when a

<sup>7</sup> Such as a tariff binding, the abolition of quantitative restrictions, or the protection of an intellectual property right.

<sup>8</sup> This function is along the lines of Grossman & Helpman, 'Protection for Sale' (1994) 84 *AER* 833.

<sup>9</sup> See Battigalli & Maggi, 'Rigidity, Discretion and the Costs of Writing Contracts' (2002) 92 *AER* 798.

contract does not specify the concessions with precision. Expectations about the behaviour of contract partners might be disappointed after the conclusion of an agreement. In short, both rigidity and discretion can make governments *ex post* unhappy with their contract.

Though incomplete contracting can in many instances explain why governments want to renegotiate, this is not the only source. The WTO agreements represent a contract which covers an immense field of trade (and related) topics and which includes at present 146 member countries. Negotiations in the run-up to the conclusion of the Uruguay Round were highly complex, and delegations finally came under considerable pressure to achieve a successful result. It is highly probable that some elements of the agreements remained contentious until the very last day of negotiation, and that they remained so even after signing. The successful conclusion of the Round was then an expression of the political will to reach an agreement on essential points. The contentious elements found their way into the agreement and might even have been given an unambiguous wording.<sup>10</sup> Yet, at the same time they were implicitly left for future renegotiation. A 'local' lack of initial commitment therefore represents the second category causing the need for renegotiation. The term 'local' is used to make clear that all governments support the overall contract and that the lack of consensus is limited to minor aspects.

## B. Explaining renegotiation provisions in international trade agreements

The previous paragraph identified why individual governments may want to renegotiate. However, this does not yet explain the inclusion of flexibility into an international trade agreement. Since renegotiation is about more protectionism, there are negative externalities on trading partners. Therefore, one might think that co-operation by means of an international agreement would have the task of avoiding just that.

In fact, there are two different reasons why governments co-operatively endow an international agreement with renegotiation provisions. The first one is identified by restating the economic concept of efficient breach of contract in political terms. Then, efficiency is reached when no government can be made better off without impairing the objective functions of other governments. For a given agreement, deviation by government *G* from a concession would be efficient in the above sense whenever the following condition is fulfilled: *G*'s political benefits from deviation are higher than the political costs incurred by compensating foreign governments for their corresponding loss. In this case, *G* could compensate its trading partners and enjoy the surplus. Mere compensation

<sup>10</sup> Abbott & Snidal, 'Hard and Soft Law in International Governance' (2000) 54 *IO* 421, at 445, by contrast, describe the following solution in case that 'one sticky problem threatens to upset a larger *package deal*': 'Rather than hold up the overall agreement, states can incorporate hortatory or imprecise provisions to deal with the difficult issues, allowing them to proceed with the rest of the bargain.'

is of course only one option: additionally, part of the surplus might also go to the trading partners. We conclude that the political costs of compensation are the minimum costs  $c_{\text{MIN}}$  that  $G$  must bear in case of deviation in order for the criterion of political efficiency to be fulfilled.

The concept of efficient breach of contract is in fact a recipe to *raise* the mutual benefits of an existing international trade agreement. The concept provides no prediction on what happens if the breach (ie, deviation) is denied, except that additional benefits are foregone. However, there is a second explanation for renegotiation provisions in international agreements, which is more explicit on possible negative consequences of denial.<sup>11</sup> We assume once more that an agreement already exists and distinguish two different cases. In the first case,  $G$  would derive benefits from deviation, but these benefits are lower than the discounted value for  $G$  of future co-operation by means of the agreement. Although a renegotiation device might be efficient, it is not necessary in order to maintain the stability of the agreement: if there is no such device, deviation will not happen, since  $G$  does not want to risk termination of the agreement.<sup>12</sup> Yet, things change considerably in the second case, where, from  $G$ 's perspective, today's benefits from deviation are assumed to exceed the discounted value of future co-operation. Now,  $G$  would resign from the agreement if the possibility for renegotiation were excluded, and co-operation would therefore be terminated. A renegotiation device could avoid such an outcome. Examining this stability argument for renegotiation further, we discover that the costs of the renegotiation device must not be higher than the discounted value of future co-operation: otherwise, the renegotiation device would be futile. We conclude that the discounted value of future co-operation defines the maximum costs  $c_{\text{MAX}}$ , and that the costs for using the renegotiation instrument must therefore be chosen from the efficiency interval  $[c_{\text{MIN}}, c_{\text{MAX}}]$  at the time of designing an international trade agreement with a renegotiation device.<sup>13</sup>

There are two problems with our stability argument. One is the concept of renegotiation proofness.<sup>14</sup> It is difficult to believe that co-operation could break down *forever* absent a renegotiation device, even if a respective threat was

<sup>11</sup> Related insights and an extensive game-theoretic treatment can be found in Rosendorff & Milner, 'The Optimal Design of International Trade Institutions: Uncertainty and Escape' (2001) 55 *IO* 829.

<sup>12</sup> In the absence of a renegotiation device, a deviation *per definitionem* means the termination of agreement.

<sup>13</sup> Referring to our stability argument, one might ask if  $c_{\text{MIN}}$  still holds under long-term efficiency considerations. Assuming a hypothetical case where the costs of the renegotiation instrument are high enough to avoid deviation always but once, yet that the costs would have to be *below*  $c_{\text{MIN}}$  in order not to exceed the discounted value of future co-operation for  $G$ , one might tend to sacrifice short-term efficiency in this single instance of deviation in order to maintain the long-term stability of the agreement. However, such a constellation would require that the discounted value of future co-operation is lower than the costs of compensation for deviation, and this is not plausible since we have in mind a local renegotiation: the deviation from a concession is marginal in relation to the total amount of concessions included in the agreement, ie, the overwhelming part of co-operation remains untouched.

<sup>14</sup> See, eg, G.W. Downs & D.M. Rocke, *Optimal Imperfection? Domestic Uncertainty and Institutions in International Relations* (1995), at 83.

pronounced by potentially affected trading partners. Such a threat would be time-inconsistent, given that all future governments would have strong incentives to co-operate again, despite an earlier deviation. Yet, an appropriate consideration of renegotiation proofness must depend on a highly specified model, which cannot be envisaged here.

The second problem is the plausibility of the condition that, from G's perspective, the political benefits of deviation today exceed the political value of co-operation in all periods to come. We contend that politicians often have an extremely short time horizon. Due to the election cycle, future benefits are discounted heavily or might not be valued at all. Short-term political benefits from deviation, by contrast, can be the decisive factor for the survival of an incumbent government. Notwithstanding this argument, it is difficult to imagine a country resigning from the WTO. On the other hand, this difficulty might just be a consequence of the fact that the WTO *has* renegotiation devices.

So far, we have assumed that an agreement exists. Yet, the stability argument can be extended and even include the claim that no agreement would be concluded in the first place without renegotiation devices—or that it would be less comprehensive. Without flexibility provisions, governments might refrain from binding their hands if they expect that unforeseeable developments could make the deviation from a concession inevitable for political reasons. This reasoning seems plausible but has an important flaw. If we assume that resignation from an agreement re-establishes the pre-contract situation, a rational government would commit itself until this unfavourable situation occurs. It could thereby temporarily reap the benefits from co-operation, and return to the pre-contract world after deviation. However, such behaviour would almost certainly entail substantial costs, for example due to an expensive initial negotiation process or due to the loss of reputation at the moment of resignation. If these costs are higher than the expected benefits from temporary co-operation, no agreement will be signed.

### C. A broad concept of renegotiation

It has already been mentioned that we use a broad concept of renegotiation, including all situations where a country wants to deviate from a concession. Looking at the WTO framework, such deviation might make use of 'conventional' means for renegotiation, such as invoking the safeguard clause, applying explicit provisions for the launch of renegotiations on previous concessions, or imposing anti-dumping and countervailing duties.<sup>15</sup> As explained further below,

<sup>15</sup> Anti-dumping and countervailing duties need not be seen as renegotiation devices when they are indeed directed against 'true' dumping or subsidization, however defined. In such cases, there is nothing to renegotiate, since there has never been an agreement on accepting such 'unfair' imports. Yet, looking at the practice of anti-dumping and countervailing duties and the attitude of panels and the Appellate Body in relevant cases, it seems that countries have substantial leeway in interpreting dumping or subsidization. They are obviously allowed to take measures beyond what is considered to be a re-establishment of 'fair trade'.

it makes perfect sense to add to this list the ‘unconventional’ act of simply violating the rules of an agreement and (possibly) refusing to comply with a subsequent DSB ruling.

Though the enumerated instruments for renegotiation seem to be very different in nature, they have important common properties. They all reflect the flexibility of the WTO agreements. When politically required by particular circumstances, members are enabled to deviate from a concession. The instruments allow the country to deviate locally without putting into question the overall adherence to the agreements, that is membership as such.<sup>16</sup> Nonetheless, each one is associated with distinct costs.

Is it really justified to talk about renegotiation when referring to measures such as invoking a safeguard clause or violating an agreement? Or are we just using a euphemistic expression for an inherently unilateral action that has not the least bargaining component? Consider the violation of an agreement: in fact, the (potential) defendant does nothing but adjust the level of concessions that he is ready to give in exchange for the current level of concessions provided by his trading partners. The latter then decide if they are ready to accept the new balance of concessions, or if they consider that the violation needs to be countered with an adjustment of their own. Taking a dynamic perspective, this mechanism of adjustment reflects a bargaining situation as long as members are ready to participate.

When using one of the renegotiation instruments, the initializing country intends to achieve an improved balance of mutual market access in a particular sector. This balance describes the country’s sectoral access conditions on the respective foreign market in relation to the foreign access on the home market. As regards the downside of such an improvement, there is a trade-off between two kinds of cost: a compensatory reverse movement in the balance of market access (possibly in various sectors) on the one hand, and a worsening reputation balance<sup>17</sup> on the other hand. There is little reputation loss if the deviation is accompanied by (market access) concessions in other sectors, or by a bilaterally negotiated reciprocal withdrawal of concessions by the affected trading partner(s). In contrast, if a member uses renegotiation instruments that are not directly connected with a compensatory change of market access (eg, violations), it suffers higher reputation costs. Adding up compensatory market access costs and reputation loss, the total costs of each instrument are determined.

<sup>16</sup> Koremenos, Lipson & Snidal, ‘The Rational Design of International Institutions’ (2001) 55 *IO* 761, at 773, call this an ‘adaptive institutional flexibility’: ‘The general goal is to isolate a special problem—such as a spike in steel imports from a few producing countries—and insulate the broader institution (in this case, the GATT/WTO) from its impact.’

<sup>17</sup> This balance is an expression for the relative reputation levels accredited to countries. It influences the relative positions of countries in future negotiations. Kovenock & Thursby, ‘GATT, Dispute Settlement, and Co-operation’, (1992) 4 *Economics and Politics* 151, at 160, acknowledge such costs and ascribe them to the breach of ‘international obligation’. They argue that, ‘... we can think of this disutility as a loss of goodwill in the international arena or the political embarrassment that comes from being suspected of violation...’.

The instruments discussed do not only show different cost structures, they can also be distinguished by the prerequisites that have to be fulfilled before they can be used. The prerequisites describe the applicability of an instrument. For example, the safeguard clause requires imports in such increased quantities as to cause or threaten to cause serious injury to domestic producers. Furthermore, the increase in imports must be the result of both unforeseen developments and ongoing liberalization.<sup>18</sup> It is easy to see that the violation of an agreement has the broadest applicability: there are no prerequisites to fulfil. Once again, a trade-off can be observed: instruments with a high level of prerequisites tend to have low reputation effects. Actions that can be taken without any precondition generally induce more reputation loss.

#### **D. Violation and non-compliance as renegotiation instrument**

If there are conventional renegotiation instruments at our disposal, why do we still need an unconventional one? At the time of signing an agreement, the parties know that the future is full of uncertainty, and that some of their concessions were only made to secure the conclusion of the overall contract. Taking this into account, the stipulation that the use of renegotiation instruments is conditional on the fulfilment of predefined prerequisites neglects the motives for renegotiation. Future states of the world might force self-interested governments to take measures even if the revealed state does not correspond to one of those contractually described as prerequisite. And a local lack of commitment means that a government has never intended to comply with the respective rule, independently of a particular state of the world. In that sense, all conventional renegotiation instruments create flexibility—but their prerequisites cannot take account of all contingencies which would warrant a renegotiation of concessions.

The violation of an agreement is not based on the fulfilment of any prerequisites. Consequently, it has an unlimited applicability and can provide flexibility in all those states of the world where conventional renegotiation instruments are not available. For example, safeguards are inherently designed to protect domestic producer interests in times of rising imports. Yet, political pressure for renegotiation might come as well from other groups, such as consumers or environmentalists. Furthermore, political pressure from producers is not only correlated with import levels and their growth rate, as the current transatlantic steel conflict confirms.<sup>19</sup> In summary, there is good reason to believe that members occasionally search for a renegotiation instrument even if the legal safeguard measure is not at their disposal.

The rules of the WTO agreements are designed to allow a breach of contract, but at the same time to limit its extent and to compensate those who are

<sup>18</sup> See Article XIX:1 GATT and Article 2:1 of the Agreement on Safeguards.

<sup>19</sup> According to the European Commission, US steel imports have fallen by 33% since 1998, see *Neue Zürcher Zeitung*, 7 March 2002, p 23. Nonetheless, political pressure became so high that the Bush administration decided to take safeguard measures in March 2002.

negatively affected. The DS mechanism fits perfectly into this concept, and the critique of lacking credibility is probably caused by the fact that its primary function is not properly understood. The DSU states:

(1) The dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system. (2) The Members recognise that it serves to preserve the rights and obligations of Members under the covered agreements, and (3) to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law.<sup>20</sup>

Based on the theoretical considerations presented above, we argue that the DS cannot do justice to (1) if flexibility is unduly restricted. The task in (2) can be understood as assigning costs to the use of flexibility. Therefore, the function of the DS is: (a) confirming violation of an agreement, thereby affecting the reputation balance between complainant and defendant; and (b) defining the level of lawful retaliation and making it public. By exercising these functions, the DS process establishes the two cost components of potential non-compliance and sets the frame for a new bargaining situation between complainant and defendant. The description of the first function seems to ignore the role of clarification as requested in (3) by emphasizing confirmation of violation only. However, as a matter of fact, the DSB almost always supports the complainant,<sup>21</sup> making confirmation of violation the typical result of panel and Appellate Body activity.

The innovations of the DSU have reinforced the purported functions of the DS. First of all, their exercise will no longer be undermined by the defendant blocking a ruling: there is no possibility of avoiding the confirmation of violation and the determination of compulsory costs. On the other hand, it is now explicitly excluded that the two functions are undertaken by some self-designated national authority. As Article 23:2 DSU formulates, '[m]embers shall not make a determination to the effect that a violation has occurred, that benefits have been nullified or impaired . . . , except through recourse to dispute settlement'. As the past requests for authorization of suspension of concessions show, members negatively affected by non-compliance tend to exaggerate the incurred nullification or impairment.<sup>22</sup> If we understand the violation of an agreement as a renegotiation instrument, such distortion in the representation of costs would impair its usefulness. Hence, it is of utmost importance that there is an objective measurement of damage.

Secondly, there is now an almost unified process for disputes under all WTO agreements. This emphasizes that the activity of the DS should not depend on the

<sup>20</sup> Article 3:2. Numbers added.

<sup>21</sup> Reinhardt, 'Adjudication Without Enforcement in GATT Disputes' (2001) 45 *Journal of Conflict Resolution* 174, at 180, notes: 'the parties already know what their obligations are: the [DSB] ruling is just a formality whose likely content the disputants could often agree on in advance'. He observes a plaintiff bias in those cases decided by a panel in the order of 4 to 1 for the GATT period.

<sup>22</sup> In the *Bananas* case, for example, the US calculated the level of nullification or impairment to be \$520 million, compared with \$191 million authorized by the DSB. In the *Hormones* case, the numbers were \$202 and \$117 million, respectively.

*nature* of violation. In fact, it would be an artificial restriction of flexibility without theoretical foundation if the possibility to renegotiate were made contingent on characteristics of goods or industry type. And indeed, it would crucially reduce the persuasiveness of our argument.

Thirdly, the complainant now has substantial agenda-setting power.<sup>23</sup> Together with a tight time frame for the work of both panels and Appellate Body, this ensures that the tasks of confirmation of violation and the determination of costs are not unduly delayed. Although an expeditious procedure cannot substitute for retroactive imposition of costs on violators, it contributes to limiting the time of free riding.

Last but not least, the possibility of an appellate review makes sure that the confirmation of violation is based on an accurate and perfectly reliable assessment of facts. This not only increases the predictability of rulings, but is especially important for a successful impact on the reputation balance as requested by the first function of the DS process. If rulings were based on an arbitrary determination, the reputation of the (losing) defendant would scarcely be affected.

Problems with implementation in general and cases of non-compliance in particular have apparently increased in recent years.<sup>24</sup> Three principal reasons for this development can be found. First of all, the broader coverage of the WTO agreements and the larger membership induce more disputes and thereby more cases in which non-compliance is an issue. Secondly, the surprisingly low number of non-compliance cases in the past is partly explained by the described possibility of a defendant blocking a negative outcome at various stages of the old DS process. It could be argued that such blocking was a form of early non-compliance with an expected unfavourable ruling. Thirdly, and most importantly, the often cited increasing confidence in the working of the new DS mechanism can also be interpreted as a growing recognition of its renegotiation aspects. Governments realize that the comprehensive agreements of the Uruguay Round have restricted their trade policy independence, yet that there is a DS process which allows them to 'buy' some flexibility and 'pay' a properly determined price for it.

### **E. Two casual observations regarding the WTO DS process**

The discussion of violation and non-compliance will now be enriched by two casual observations as regards the WTO DS process. They are evidence that members of the WTO have actually had in mind to endow the agreements with a good portion of such flexibility when designing them. The first is that bilateral negotiations to find a mutually acceptable solution are *de jure* and *de facto* the preferred tool for the settlement of disputes. And the second is that when bilateral negotiations fail to prevent the DSB from issuing a ruling, and the defendant refuses to comply, there is *de facto* no enforcement effort.

<sup>23</sup> See Büttler & Hauser, *supra* note 1, at 509.

<sup>24</sup> See Pauwelyn, 'Enforcement and Countermeasures in the WTO: Rules are Rules—Toward a More Collective Approach' (2000) 94 *AJIL* 335.

As to the first observation, the DSU asks that bilateral negotiations take place before and during the formal DS process. This is generally seen to be a very desirable feature. We definitely agree, but suggest that the desirability of bilateral negotiations does not end at the moment of a DSB ruling. If a mutually acceptable solution 'is clearly to be preferred' (Article 3.7 DSU), there is no logical argument that invalidates this statement for the time after a DSB ruling. In fact, only the negotiation after a ruling can profit from a more equilibrated balance of bargaining positions due to the assignment of costs to the (losing) defendant by the DSB.

There is another crucial point that should be emphasized. The DSU requires that any solution found in bilateral negotiations shall be consistent with the WTO agreements and be notified to the DSB.<sup>25</sup> It is evident that the first request is almost useless without the second, but that notification is rarely taken as seriously as one might hope. However, even in cases where bilateral solutions are properly notified and in principle consistent with the agreements, caution is advisable in judging their economic success. There is a strong presumption that defendants are tempted to keep the substance of an initial violation, but to find an arrangement which circumvents WTO rules and is difficult to challenge therefore.<sup>26</sup> Although one might think that this is equally true for bilateral settlements before *and* after a DSB ruling, it is plausible to assume that the transparency of a solution is significantly higher in the second case. A DSB ruling does not only alter the bargaining positions, it also directs public attention to the dispute. The more 'problems' arise with the implementation of a ruling, the more certain it is that the media are carefully tracking any attempts of rapprochement between the parties and reporting the results. An eventual settlement that comes after a ruling might therefore be much closer to the rules than a more or less unnoticed deal in the run-up to a DSB ruling.

The second observation is the *de facto* absence of enforcement in the WTO. It is important to distinguish two aspects of this absence. One is that there has always been a *natural* limitation of enforcement efforts. Sovereign countries cannot be forced to behave in a particular way as long as drastic measures (such as military intervention) remain excluded. However, this does not mean that any enforcement effort is useless, and this brings us to the second aspect: countries can consciously create *artificial* limits of enforcement that are (far) below the natural limits.

What leads us to the conclusion that the natural potential for enforcement is not exploited in the WTO? A first indication is that panels and the Appellate Body generally refrain from suggesting specific implementation measures. Although they are allowed to formulate such suggestions,<sup>27</sup> they rarely go beyond

<sup>25</sup> Article 3:5 and 3:6 DSU, respectively.

<sup>26</sup> See Zimmermann, 'Gewährleisten umgesetzte WTO-Streitschlichtungsurteile offene Märkte? Eine Betrachtung am Beispiel des Zeitschriftenfalles' (2001) 56 *Aussenwirtschaft* 359.

<sup>27</sup> Article 19:1 DSU provides that: '[i]n addition to its recommendations, the panel or Appellate Body may suggest ways in which the Member concerned could implement the recommendations'.

'standard recommendations'. Three points follow immediately: defendants are not convincingly discouraged to maintain permanently at least part of the protective element of their initial violation;<sup>28</sup> secondly, due to the lack of guidance, any implementation is delayed; and last but not least, the final determination whether compliance has occurred needs greater scrutiny.

Enforcement is further weakened by the strictly limited market access costs that the DSB imposes in cases of non-compliance. The only function of such costs is restoring the balance of concessions. Due to the difficulties in calculating reputation costs, it cannot formally be proven here that total costs for non-compliance (ie, market access costs plus reputation costs) are actually lying in the efficiency interval  $[c_{\text{MIN}}, c_{\text{MAX}}]$  defined above. However, it is contended that the signatories of the WTO at least had this interval in mind when designing the enforcement rules. The aim of restoring the balance of concessions is clearly inspired by  $c_{\text{MIN}}$ : even if reputation costs are low or almost absent, total costs will not fall short of the lower limit of the interval.<sup>29</sup> On the other hand, the total costs miss by far the maximum thinkable cost level of non-compliance: retaliation is strictly limited in its scope and duration. Only the complainant is allowed to retaliate, and there are restrictions as regards the choice of products for retaliation. In fact, the costs for non-compliance are not only below the maximum thinkable level, they are also below  $c_{\text{MAX}}$ . This can be seen if the discounted value of future co-operation for the government is approximated by today's political value of membership. Since non-compliance is not 'punished' with the denial of membership, the signatories wanted to keep total costs below  $c_{\text{MAX}}$ .

#### IV. SOME NORMATIVE CONSIDERATIONS

The argument so far has been merely *positive* in nature. We have identified the behaviour of self-interested governments in an international setting and described the flexibility of international trade agreements such as the WTO as an intended and politically desired feature of the world trading order. Now, four normative considerations are made.

The first consideration starts with the observation that the government objective function can differ from the maximization of social welfare. Although flexibility might be desirable from a global political perspective, it might not be in the interest of society. Obviously, in every period where flexibility is

<sup>28</sup> Horn & Mavroidis, 'Remedies in the WTO Dispute Settlement and Developing Countries Interests', *WTO 2000 Capacity Building Project Background Paper* (1999), argue that, '[w]hen limiting themselves to recommendations, WTO adjudicating bodies give ample discretion to the losing party. WTO Members are then, in principle, free to adopt any conduct they deem necessary in order to bring their measures in conformity with their international obligations.'

<sup>29</sup> This of course assumes that the restoration of the balance of concessions follows immediately after the violation. In reality, this is not given, but could be achieved by retroactive compensation.

applied, the ideal of free trade is compromised. Even if society has a strong preference for redistribution, trade intervention brings about greater allocative distortion than other redistributive instruments. Flexibility would therefore be a bad feature of the world trading system.

Valid as this argument is, it neglects two points. To begin with, redistribution is not the only aim of renegotiation, as the *Hormones* case exemplifies. Whereas border tariffs might primarily have been instruments for generating rents, domestic regulations are based on a variety of purposes. Condemning flexibility would therefore restrict trade policy even when it has no redistributive intention. Furthermore, if the lack of flexibility prevents governments from concluding new agreements, or impairs their enthusiasm towards existing ones, the negative social welfare consequences should by far outweigh those related with sporadically applied flexibility.

The second consideration relates to the predictability of world trade. Predictability is essential in order to reduce the risk premium for international transactions. It is argued that it could be strengthened further if international trade agreements created individual (private) rights, enforceable by national courts. Then of course, flexibility in trade policy would disappear.

Again, although the aim of predictability cannot be dissented, some objections to the argument as such must be brought up. Firstly, the costs of flexibility *also* contribute to the predictability of world trade by limiting the instances of applied flexibility. Secondly, little is won if predictability for trade covered under international agreements is increased, but the agreements are not comprehensive—this, of course, again relates to our stability argument. Thirdly, individual rights might be in conflict with social welfare, just as the government objective function is.<sup>30</sup> The *Hormones* case is again a good example: one might wonder what would happen if European beef importers attempted to impose their right for selling US hormone-treated meat.

Another important consideration relates to the fact that flexibility is obviously not distributed evenly among countries today. Small countries risk being denied any renegotiation instrument by the implicit threat of powerful nations to impose additional costs on them inside and outside the WTO sphere. As an example, both the US and the EC might credibly threaten to stop development assistance (eg, in the form of the *Generalized System of Preferences*) if a developing country does not comply with a DSB ruling. On the other hand, powerful countries might get flexibility too cheaply when applied against small nations because the latter could be unable to retaliate due to their foreign trade structure.

That said, we do not think that the argument can undermine the claim that flexibility is valuable and that a strict rule orientation is not desirable. In particular, one does not get rid of power imbalances by just strengthening rules. Instead of condemning flexibility, mechanisms should be designed that guarantee an equal distribution of flexibility and an appropriate cost level.

<sup>30</sup> See the contribution by Joel Trachtman in this volume.

Although this is not easy and out of reach for this paper, it merits at least as much attention as the debate about means for strengthening rule orientation.

The last consideration touches upon the consistency of our flexibility argument. One might claim that we implicitly fall back on the concept of rule orientation when describing the role of the DS process in face of violations. Otherwise, we would have to admit that the rules of the DSU are flexible, too, and then, all rules would be 'up for grabs'.<sup>31</sup>

In order to rebut this point, we argue that the DSU is different in nature from all those WTO agreements that consist of substantive norms on trade (de)regulation. Claiming that flexibility is a useful feature of the world trading order is neither suggesting that *any kind* of flexibility is desirable, nor that there is no need for provisions that prevent abuse. The DSU frames the use of flexibility and in particular defines its price. It stands above the other WTO agreements, since it is the only agreement that deals with violations of them. This special function allows us to exclude it from flexibility in application.

#### V. A NEW ASSESSMENT OF IMPORTANT DISPUTES: BANANAS, HORMONES AND FSC<sup>32</sup>

##### A. A short review

In 1993, the EC introduced a regulation establishing a harmonized regime on the importation of bananas. It consisted of a tariff quota system and continued historical privileges for African, Caribbean and Pacific (ACP) countries. These privileges had already been challenged before by a group of Latin American countries, but the EC and the ACP countries had blocked the panel report. The same happened with a second panel report in 1994. After the conclusion of a bilateral settlement with the original complainants and after the signing of the Uruguay Round agreements, a new group of countries (including the US and Ecuador) filed a complaint. For the third time, the EC lost the case in front of the panel and Appellate Body in 1997. The EC seemed to accept the ruling by requesting consultations as to the 'reasonable period of time' for implementation. An arbitrator decided that compliance with the ruling had to be reached by 1 January 1999. The EC made some amendments to the banana regime, yet these did not satisfy the complainants. A controversy started about the relationship between Articles 21.5 and 22 DSU, ie, about the question when the right to retaliate arises. Not surprisingly, the EC pushed for a renewed DS procedure, which should have to determine if the amended regime was consistent with the DSB ruling. The US on the other hand openly threatened to retaliate and indeed

<sup>31</sup> We owe the pronounced statement to Volker Rittberger, who made explicit this last consideration.

<sup>32</sup> See *EC—Regime for the Importation, Sale and Distribution of Bananas (WT/DS27)*, *EC—Measures Affecting Meat and Meat Products (Hormones) (WT/DS26)*, and *US—Tax Treatment for 'Foreign Sales Corporations' (WT/DS108)*.

requested authorization to suspend concessions only two weeks after the end of the officially granted implementation period. This request was withdrawn in order to enable arbitration on the appropriate level of retaliation. After the arbitrators had requested further information on 2 March 1999 and thereby postponed a decision, the US nonetheless started to suspend customs clearance for a number of products on the next day. This step was subsequently challenged by the EC.<sup>33</sup> About one month later, the arbitrators finally determined the appropriate level of retaliation, which was set significantly lower than requested by the US. The US subsequently imposed retaliatory tariffs with an impact of \$191 million. In May 2000, the US further increased pressure by adopting a so-called carousel provision, which brings about a periodical change of products affected by retaliatory tariffs. The EC requested consultations, but no additional steps in the DS process were taken. On 11 April 2001, a bilateral agreement was reached between the US and the EC.<sup>34</sup> The latter agreed to crucially modify the banana regime, leading to a tariff only system, due to start on 1 January 2006 at the latest. In return the US suspended its retaliatory tariffs on 1 July 2001, and they were permanently lifted after the EC adoption of the amendments.

There has been a long conflict across the Atlantic about the use of growth-promoting hormones. During the 1980s, the EC gradually reinforced their negative stance towards such additives. This development occurred despite a substantial amount of scientific work that found no indication of risk for human health. In 1989, the EC banned imports of red meat from animals treated with certain growth hormones. The US, an important exporter of hormone-treated beef, claimed that these measures represented a barrier to trade inconsistent with GATT rules. Similar to the *Bananas* case, all attempts to have this practice officially condemned by GATT authorities failed due to the blocking by the EC. Under the WTO, consultations about the disputed import regime started in 1996. A panel ruled against the EC in 1997, and so did the Appellate Body shortly after. Again, an arbitrator was needed to determine the reasonable period of time for implementation, and the respective period ended on 13 May 1999. Since the EC ignored the ruling, and further attempts to negotiate compensation on other issues failed, the US were authorized in July to impose retaliatory tariffs against imports of the EC up to the value of \$117 million. These are still in place.

The origins of the *FSC* dispute can be traced back to 1971, when the US introduced the *Domestic International Sales Corporation* (DISC) provisions. These included a tax incentive to export and were challenged early by the EC. In 1984, the US introduced the *FSC* provisions, replacing the DISC system. The EC was not satisfied with these amendments, but further steps were postponed until 1997, when the EC requested consultations under the new DSU. A panel

<sup>33</sup> The step lost its significance after the arbitrators had made their decision, and was suspended.

<sup>34</sup> See Press Release of the European Commission, 11 April 2001, Document No IP/01/562. On 30 April 2001, an additional agreement could be reached between the EC and Ecuador. It is consistent with the US-EC agreement. See European Commission, Press Release from 30 April 2001. Ecuador in return gave up its right to suspend concessions as authorized by the DSB.

supported the claims of the EC in 1999, and the Appellate Body essentially upheld its conclusions. Just after the time for implementation had expired, the US amended the FSC provisions in November 2000. Again, the EC considered the reforms to be unsatisfactory and asked the WTO to authorize retaliation. However, this process was suspended, and the two parties agreed to ask a compliance panel whether the amended FSC provisions violate WTO agreements. Its report was circulated in August 2001 and emphasized a continued inconsistency. The Appellate Body confirmed the ruling of the compliance panel in all essential points in January 2002. In August 2002, the EU was entitled to impose more than \$4 billion in trade retaliation.

## B. Analysis

Looking for similarities among the three cases, one might start by noticing that all were lost by the defendant, who clearly violated one or various WTO agreement(s). The unwillingness to comply had two principal reasons:

- (1) The disputed measures were of critical importance to the defendant. The import regime for bananas may make little economic sense for both the EC and ACP countries. However, it is probably the strongest *political* manifestation that the EC are still willing to assume responsibility for the destiny of their former colonies. The ban on hormones might not be justifiable by scientific research, but it seems to be the only possible answer to widespread fears among consumers in European countries. And the FSC regime is an essential part of a highly complex tax system, the abolition of which would cause considerable political and economic problems in the US.<sup>35</sup> Moreover, tax policy issues generally provoke high resistance among sovereign states when their autonomy seems to be at stake.
- (2) The WTO agreements<sup>36</sup> did not provide an adequate instrument for renegotiation besides violation and subsequent non-compliance. In the *Bananas* case, the EC and the ACP countries were able to negotiate a waiver concerning the Lomé Convention in 1994, yet this waiver only provided an exemption from the most-favoured-nation clause and therefore was an unsuitable basis for the tariff quota system. Since the ban on hormone-treated beef was justified by consumer fears, the merely producer-oriented safeguard mechanisms were not at the EC's disposal. A general exception based on Article XX(b) GATT in order to protect human health could not be invoked, since the EC had agreed<sup>37</sup> to take respective measures only in accordance with an

<sup>35</sup> See Skeen, 'Knick-Knack Paddy Whack Leave the FSC Alone: An Analysis of the WTO Panel Ruling That the U.S. Foreign Sales Corporation Program is an Illegal Export Subsidy Under GATT' (2000) 35 *New England Law Review* 69, at 71 and 95. She discusses in particular the problems associated with replacing the FSC regime by a VAT system and concludes: '[s]olutions for the United States are limited and plagued with problems of feasibility and detrimental economic consequences'.

<sup>36</sup> And their predecessor, the GATT, respectively.

<sup>37</sup> As part of the Agreement on the Application of Sanitary and Phytosanitary Measures.

appropriate assessment of risk. As to the FSC case, both the complexities and interrelationships of tax regimes on the one hand, and the reluctance of the US to let others interfere with their sovereignty on the other hand, have been too strong so far to enable the parties to find a mutually acceptable solution by means of conventional renegotiation tools.

From a rule-oriented perspective, it is surprising to observe the readiness of the complainants at various stages to *renegotiate* an issue which had already been decided in their favour by the DSB. In the *Bananas* case, the EC did not only violate an agreement; they also blocked the initiation of a DS process as long as possible. They lost before the panel and the Appellate Body. They fought for an interpretation of the DSU which would simply have given them the right to maintain a deviation from contract without paying an appropriate price. They initiated a DS process themselves to challenge US retaliation measures. And, most noteworthy, they continued their non-compliance even after the arbitrators had authorized the imposition of US retaliatory tariffs and simultaneously rejected the EC claim that the amended regime would be inconsistent with WTO rules.<sup>38</sup> Despite such an intractable attitude, the US de facto never abandoned the policy of giving favourable consideration to striking a deal with the EC. The US were content with a level of authorized retaliation which was considerably lower than requested. And finally, they signed a bilateral agreement with the EC, which allows a temporary maintenance of the tariff quota system, and suspended (and later terminated) all retaliatory tariffs. The US obviously accepted the strong demand for renegotiation expressed by the EC. The US pressed for a DSB ruling in order to get a more favourable bargaining position, but they did not alter their readiness to negotiate after it had become obvious that the EC would not comply. On the condition that the latest bilateral agreement holds, a long standing dispute will have been successfully settled.

Obviously, such a positive conclusion is not yet justified as regards the *Hormones* case. A compromise seems to be even more difficult after the latest moves of the EC to ban permanently the growth hormone 17-beta oestradiol for any use with farm animals and to ban provisionally a group of other growth hormones used in beef production. In January 2002, a new regulation was passed which formulates the so-called 'precautionary principle' in EC food policy and which is refused by the US.<sup>39</sup> The authorized US retaliatory tariffs are still in place. However, the dispute has not escalated at all. As such, the above-mentioned carousel provision, which would also have affected retaliatory

<sup>38</sup> See Salas & Jackson, 'Procedural Overview of the WTO EC—Banana Dispute' (2000) 3 *JIEL* 145, at 149.

<sup>39</sup> See Regulation (EC) 178/2002 of the European Parliament and of the Council of 28 January 2002 laying down the general principles and requirements of food law, establishing the European Food Safety Authority and laying down procedures in matters of food safety. The US generally regards the principle as unscientific and arbitrary, see *Bridges Weekly Trade News*, Vol 6, No 7, 26 February 2002.

tariffs in the *Hormones* case, has not yet been implemented by the US. And though there are no signs that the EC are rethinking their position, a future bilateral agreement between the parties is not excluded.<sup>40</sup> Both sides have an interest in continuing bilateral talks: the US want to assure a more favourable market access for their beef products, and the EC is continuously confronted with the costs of retaliatory action and an impaired reputation balance. The violation of the agreement and the subsequent non-compliance by the EC had created a bargaining situation that was substantially altered by the DSB rulings. This bargaining is obviously not completed yet, and the structure of the final solution cannot be predicted so far. Nonetheless, it would be wrong to talk about failure of the DS process. Its contribution has been essential as it strengthened the interest of the EC to find a solution beyond simply refusing to act—the latter behaviour has become much more expensive.

The FSC case is undoubtedly the biggest challenged transatlantic trade distortion. It is therefore of paramount interest to the study of dispute settlement. Unfortunately, the latest ruling of the Appellate Body is still too recent to allow a complete assessment of the conflict. However, there are a number of indications that support the conclusion that a solution will be found on the bargaining table, and that no escalation is to be expected. There is no longer any doubt that the FSC provisions and their half-hearted amendments are in violation of WTO agreements. Their damaging effect on competing EC companies is huge, as the authorized level of retaliation confirms. Yet, just as the EC suspended requests for retaliatory measures and concluded an understanding<sup>41</sup> with the US in September 2000, Brussels now officially recognizes that the latest Appellate Body ruling will not lead to the simple abolishment of the FSC system.<sup>42</sup> Rather, new negotiations will take place. These will not be the same as before, since the balance of power between the two parties has considerably changed: it is now public knowledge that the FSC system is against multilaterally agreed rules. Furthermore, the EC is able rightfully to impose retaliatory measures. On the other hand, the EC do not possess unrestricted capabilities to impose a solution which is unacceptable for the US: any retaliation will be limited by binding arbitration, and it will have to be thoroughly designed in order to reduce harmful consequences for the EC (importers) themselves.

<sup>40</sup> EC Trade Commissioner Pascal Lamy criticized the adoption of the carousel provision as ‘a step backwards in attempts to *negotiate* a settlement’ (see *Bridges Weekly*, Vol 4, No 19, 16 May 2000; emphasis added). This statement came *after* the formal conclusion of the DS process and the introduction of authorized retaliation by the US.

<sup>41</sup> See *Understanding between the European Communities and the United States Regarding Procedures under Articles 21 and 22 of the DSU and Article 4 of the SCM Agreement*, published by the WTO as Document WT/DS108/12 on 5 October 2000.

<sup>42</sup> Pascal Lamy: ‘Now it is up to the US to comply with the WTO’s findings to settle this matter once and for all. *As to how, we look forward to rapid US proposals.*’ Press release, Brussels, 14 January 2002. Emphasis added.

## VI. CONCLUSION

Despite the fact that various analysts constantly predict the outbreak of notable ‘trade wars’, we do not observe such a development. The origins of the important disputes on bananas, hormones and FSC date back at least to the 80s. Nonetheless, they could not impede the two most powerful members of the WTO from successfully concluding the Uruguay Round. Nor did they deter them from launching a new round of liberalization in Doha in November 2001. More importantly, bilateral trade volumes grew rapidly during the years of alleged trade war: US merchandise exports to the EC more than doubled between 1990 and 2001, whereas US imports from the EC almost tripled.<sup>43</sup>

Non-compliance need not necessarily be analyzed under the perspective of an inadequate rule orientation. It can also be interpreted as part of renegotiation. Such renegotiation is unavoidable given the prevalence of incomplete contracting and local lack of consensus. Recognizing this, the WTO DS process primarily has the role of shaping a new bargaining environment by attributing costs to the continuing violation of contract.

Our argument suggests that non-compliance is much less a problem than many observers believe. This is not to say that the current DS is already perfect. Contentious and ambiguous issues such as the determination of a ‘reasonable period of time’ or the relationship between Articles 21.5 and 22 DSU must be tackled as soon as possible. Furthermore, free riding until the end of the implementation period could be made impossible by retroactive compensation. Yet, any reform would have to be directed towards reinforcing the renegotiation role of the WTO DS process, not towards banning non-compliance. Future research might test empirically to which extent the paradigms of rule orientation and flexibility contribute to a liberal trading regime. As we have demonstrated, there are strong indications which question the superiority of rule orientation.

<sup>43</sup> Based on data from the European Commission, DG Trade, November 2002.