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## Revisiting the “Compliance-vs.-Rebalancing” Debate in WTO Scholarship: Towards a Unified Research Agenda

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### ***Abstract***

This paper constitutes an attempt to reframe and eventually deflate the ongoing “compliance-vs.-rebalancing” debate which has permeated WTO scholarship for the last 10 years. Our main criticism concerns the *substance* of the entire debate. We find that scholars on both sides of the compliance/rebalancing controversy put an unduly rigid emphasis on the subsequent issues of WTO *enforcement* and the interpretation of the wording of the dispute settlement understanding. They thereby neglected *systemic* issues of contracting, viz. the nature of contractual entitlements, the need for trade policy flexibility mechanisms and the optimal design of the appropriate remedies.

We redefine and recalibrate the compliance/rebalancing controversy along the lines of the *nature* of the WTO contract. This results in to three key findings: First, none of the two schools of thought succeeds in giving an accurate picture of the WTO treaty. Second, the two perspectives actually portray two strikingly different concepts of the WTO contract, and therefore have been at cross-purposes from the very beginning. This implies a third finding: The two schools of thought essentially describe different facets of the same complex WTO contract. Hence, they have hardly been at loggerheads at all, and are actually complementing each other in important aspects.

We lay out a unified research agenda that practitioners, economists, trade lawyers, and international relations scholars alike can accept. The agenda may contribute to reconciling the two opposing views and help WTO scholarship tackle the real systemic issues of the WTO Agreement.

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## **Revisiting the “Compliance-vs.-Rebalancing” Debate in WTO Scholarship: Towards a Unified Research Agenda**

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Summary: This paper constitutes an attempt to reframe and eventually deflate the ongoing “compliance-vs.-rebalancing” debate which has permeated WTO scholarship for the last 10 years. At face value, this controversy circles around *object and purpose* of WTO enforcement and the legal nature of dispute panels’ recommendations: Compliance advocates maintain that the objective of WTO enforcement is to induce compliance with DSB panel/AB rulings, and to deter future violations of the Agreement, while rebalancing advocates detect an inherent “pay-or-perform” logic in WTO enforcement.

In the paper we examine the shortcomings of each approach separately. Our main criticism, however, concerns the *substance* of the entire debate. We find that scholars on both sides of the compliance/rebalancing controversy put an unduly rigid emphasis on the subsequent issues of WTO *enforcement* and the interpretation of the wording of the dispute settlement understanding. They thereby neglected *systemic* issues of contracting, viz. the nature of contractual entitlements, the need for trade policy flexibility mechanisms and the optimal design of the appropriate remedies.

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**Keywords:** WTO, dispute settlement, incomplete contracts, remedies, enforcement

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## 1 The tenacious compliance/rebalancing debate

The “compliance-vs.-rebalancing” debate has been simmering inconclusively for over a decade in WTO scholarship. Our objective is to assess the true nature of this controversy, and to define a common basis of both the compliance and the rebalancing perspective. We do so by reframing the discussion and by reformulating the underlying implicit research questions that should have been driving the debate in the first place.

At face value the compliance/rebalancing controversy is one about the object and purpose of WTO enforcement, and the legal bindingness of reports issued by dispute settlement (DS) panels or the Appellate Body (AB). In simple terms, the *compliance* perspective on the WTO contends that the objective of WTO enforcement, regulated in the Dispute Settlement Understanding (DSU), is to induce strict and prompt compliance with DS panel/AB rulings and to deter future violations of the Agreement. This view stands in stark opposition to the *rebalancing* school, which essentially sees the objective of dispute settlement as supplying an insured safety-valve for injurers in a dynamic and complex world: By equilibrating the mutual balance of concessions, WTO enforcement mechanisms ensure the twin-goal of compensating the victim and providing the injurer with an efficient opt-out possibility.

The compliance/rebalancing debate was led sternly, but ultimately stayed inconclusive. Eventually it seems to have petered out, with scholars on both sides of the divide returning to their respective paradigms and ignoring the other side’s contentions, criticisms and concerns. We will argue that the discussion has lost momentum not because it is insignificant or minor, but because its subject matter was off the mark – the debate was wrongly framed. Reviewing origin and essence of the debate, we will find that scholars of both camps neglected to enter into the deeper, systemic issues of contracting. We will contend that the compliance/rebalancing rift should be understood less as a discussion about object and purpose of WTO *enforcement*, but first and foremost as one about the *nature* of the contract proper. Logically, any debate that solely deals with issues of enforcement of *impermissible* contractual deviations risks being vacuous if it is not preceded by a thorough discussion of what constitutes *permissible* behavior in the first place. In other words, without a rigorous assessment of the underlying *contract* and its system of non-performance any serious debate about enforcement must remain futile.<sup>1</sup>

Acknowledging this basic insight we will reframe the controversy by putting those questions at center stage that should have been at the core of the debate from the very beginning. Using a methodology originating from incomplete contract theory, we will embed the two opposing perspectives in a more encompassing discussion on the *essence* and *nature* of the WTO contract: This will include an examination of (i) basic contractual entitlements exchanged by WTO Members (the “primary rules” of contracting), (ii) rules of entitlement protection or trade policy

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<sup>1</sup> *Ex post* non-performance, or escape, from previously agreed contractual commitments, can happen in one of two ways: First, it can be contractually specified and therefore legitimate. Whenever parties agree on the permissibility of withdrawing from previously made concessions, this arrangement – called *escape*, *default*, or *excuse from obligations* – forms an integral part of the contract. Non-performance as agreed upon then represents *intra*-contractual, permissible behavior, not a violation of the terms of the accord. Generally, escape rules can be organized as opt-out mechanisms, or as renegotiation clauses. A second form of *ex post* non-performance constitutes *extra*-contractual behavior and as such is illegal. As a convention, this behavior shall be termed *contractual defection*, *violation*, *infringement*, *deviation* or *misdeemeanor*.

flexibility mechanisms (the “secondary rules” of contracting), and (iii) rules of enforcement and dispute settlement (the “tertiary rules” of contracting).

Reinterpreting the compliance/rebalancing rift in light of this more holistic context, we come to three key conclusions: First, the two schools of thought are based on two strikingly different notions of the WTO Agreement.

- The *rebalancing* camp reduces the WTO to a single-entitlement contract in which signatories exchange reciprocal market-access concessions or tariff liberalization commitments. These mutual liberalization commitments are *de facto* protected by a pure “liability rule” of trade policy flexibility: Every signatory can opt out of the WTO Agreement anytime and under any circumstance, given the escaping country pays compensation to the injured Member, or at least does not obstruct the victim’s retaliatory self-help measures. Rebalancing proponents are thus exclusively concerned with *intra*-contractual safety valve mechanisms and are largely agnostic over all issues of enforcement of *extra*-contractual behavior. Hence, they make no systemic difference between *intra*-contractual non-performance (trade policy flexibility) and *extra*-contractual rules of dispute settlement and enforcement.
- In the eyes of *compliance* proponents, the WTO is a multi-entitlement treaty, yet, they fail to conceptually discriminate between different entitlements traded in the WTO. Commentators of the compliance camp are primarily engrossed in the international legal bindingness of panel rulings pursuant to *extra*-contractual behavior, and by so doing largely ignore the systemic need for *intra*-contractual escape in the WTO contract, i.e. trade policy flexibility. According to the compliance view, *every* contractual right and obligation is protected by a “property rule” of trade flexibility, and enforced by the strong language of the DSU, whose explicit task it is to coerce the violator into compliance with the rules of the game and the rulings of dispute panels. The party wishing to escape can buy off the owner’s entitlement through *renegotiations*. However, why procedures for renegotiations are so weak and enforcement remedies are so “toothless” in the current DSU remains unaddressed by compliance advocates.

Our second key finding is that neither the compliance- nor the rebalancing school of thought manages to present an accurate and all-encompassing understanding of the general nature of the WTO contract and its system of non-performance.

Third, assessing the two schools of thought in light of the nature of the contract, we reach a surprising conclusion: There is actually no antinomy between the compliance and rebalancing paradigms at all. In fact, the two views are not paradigms in the true sense of the word at all; they merely discuss *different facets of the same issue*, namely the nature of the WTO contract. Both rebalancing and compliance are the fundamental for understanding the WTO contract in its entire complexity, whereby rebalancing is an essential ingredient for the organization of *intra*-contractual flexibility, while compliance is the lynchpin of *extra*-contractual enforcement. Hence, the two perspectives can actually be seen as complementary, not as mutually exclusive.

These three key findings motivate us to encourage scholars of both schools to put aside their quarrel, and to conjointly tackle the larger problems at hand, namely to understand the true nature of the WTO contract and to work towards a sensible reform of the WTO’s system of trade policy flexibility and enforcement. WTO scholars on both sides of the compliance/rebalancing discourse should move away from the secondary question of what WTO enforcement currently *is*; instead they should think harder about the more pressing issue of what the Agreement as such *is conceptualized as* and how it should be reformed to become more equitable, efficient, and just.

The remainder of the paper proceeds as follows: Section 2 will review the origin and essence of the decade-old compliance/rebalancing debate. Section 3 will take a critical look at the argumentation of both views separately, whereas section 4 will appraise the substance of the discussion. Challenging the substance of the entire debate, we will raise a more comprehensive set of research questions, namely those dealing with basic issues of contracting. It will be assessed how the two opposing perspectives answer these new research questions. It will turn out that not only do rebalancing and compliance proponents portray two strikingly different contracts. In addition, we will show that the debate ignored a third view of the WTO, the “inalienability” perspective, a view rooted in the constitutionalist tradition and the “commitment school” of trade agreements. Section 5 will conclude, draw some lessons learned, and suggest an integrative research agenda which leaves behind the outdated argument over rebalancing and compliance.

## 2 Understanding the debate

An informed debate on object and purpose of WTO enforcement is vital for at least two reasons: First, in the face of severe discontent with the current DS system of the WTO, a huge number of reform proposals was tabled by WTO Member States and trade scholars alike.<sup>2</sup> These proposals differ tremendously in scale, scope, circle of addressees, level of ambition etc. In order to make sense of the wide array of issued reform proposals, it seems expedient to have a clear conception of the *object* and *purpose* of WTO enforcement before addressing the subordinate discussion concerning dispute settlement procedures, instruments and tools.<sup>3</sup> Second, WTO arbitrators ought to have a clear idea of their mandate under the WTO Agreement when they are asked to calculate the level of trade damages (“nullification and impairment” in WTO parlance) pursuant to an escalating WTO dispute: Whenever a defendant party is found in violation of its obligations under the WTO Agreement, and the subsequent negotiations over voluntary tariff compensation break down, the arbitrator is summoned to quantify the trade damage incurred by the injured complainant (Art. 22.4 and 22.6 DSU). Yet, as some scholars have rightly contended, it is notoriously difficult for WTO arbitrators to give meaning to Art. 22.4 DSU and to calculate trade damages, without a proper idea of what WTO enforcement is to achieve in the first place (cf. Lawrence 2003, Araki 2004, Josling 2004, Kohler 2004, Jürgensen 2005, Sebastian 2007).

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<sup>2</sup> The WTO dispute settlement body (DSB) has been criticized on issues of participation, adjudication and implementation. For a comprehensive overview of discontent, criticism and reform proposals of the DSB, see WTO (2007, section II.D.3) or Schropp (2008, section 6.1). A number of WTO Members have argued in favor of opening renegotiations on DS: Eighty-nine proposals to reform the DSU have been tabled in negotiations so far (as until July 2007) – by individual Members or country groups from all geographical regions, initially covering 24 out of the 27 Articles of the DSU (see generally the WTO document series TN/DS/xxx).

<sup>3</sup> The precedence of *why?* (enforcement objectives) over *how?* (enforcement instruments and procedures) is after all a logical prerogative. Unless one knows what the DSU is meant to achieve, it is difficult to discuss whether it performs well or deficiently. Sebastian (2007, p. 364) perceptively notes: “A view about when the intensity of retaliation is too much or too little would appear to require a theory about the purpose intended to be served and the corresponding effects sought to be produced by WTO remedies.” Unfortunately, as Hauser and Roitinger (2004) show, most trade practitioners and WTO scholars cast doubt on existing enforcement instruments without having previously addressed what purposes enforcement is to achieve in the first place. Instead, they merely argue about conclusions drawn from divergent sets of underlying – implicit – assumptions.

## 2.1 Origin and essence of the compliance/rebalancing debate: The objective of WTO enforcement

The compliance/rebalancing debate on object and purpose of WTO enforcement was triggered by an editorial by Judith Hippler Bello (1996) in the *American Journal of International Law*. Her article was a reaction to American opponents to the WTO Agreement, who feared that the treaty would threaten U.S. sovereignty by allowing unelected Geneva bureaucrats to undermine democratic legislation. Bello reassured her compatriots that WTO Members in contravention of a WTO Agreement had a distinct choice between adhering to a dispute panel's/the AB's recommendations (mandating that the defendant brings its practices or law into consistency with the texts of the Annexes to the WTO Agreement) on the one hand, and deliberately "opting out" of the respective Agreement on the other. The precondition for opting out, Bello claimed, is the provision of compensation, or – in case mutual agreement is lacking – the toleration of a suspension of concessions. Concerning the bindingness of panel recommendations, she contended that "[t]he only truly binding WTO obligation is to maintain the balance of concessions negotiated among members" (*ibid.*, p. 418).

This view was vividly refuted by John Jackson (1997b), who contended that a WTO Member is in no way free to "pay or perform" after having been condemned by the international trade court:<sup>4</sup> Each Member is under a strict international legal obligation to comply with a dispute panel's recommendations.

It soon became obvious that Bello's and Jackson's contentions as to the legal status and effect of panel reports were each representative of two distinct schools of thought, perspectives, or preconceptions of WTO enforcement. Is the defendant to *compensate* the victim, or are DS procedures to add a punitive element aimed at inducing *compliance* by deterring future deviations from happening? The two mindsets, in fact, seemed to neatly divide WTO scholarship into two rivaling camps – that of "compliance" advocates and that of "rebalancing" proponents.<sup>5</sup> The emerging academic dispute of compliance-vs.-rebalancing has been waged in only a handful of papers, in which authors of both schools of thought attempt to frame the controversy, to condense the logic inherent in their respective contention, and to disqualify the other camp.<sup>6</sup> Yet, the framers of this controversy apparently see their contentions as *representative* of an entire school of thought. In support of their respective views, authors draw widely upon relevant WTO literature, extract the underlying (largely implicit) assumptions and methodologies therein, and bring forth their inferences accordingly. The argumentative logic behind these two rivaling mindsets has to be

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<sup>4</sup> The term "pay or perform" is linked to Judge Oliver Wendell Holmes' famous dictum, namely that private contracts are promises to perform according to the letter of the accord, or to opt out of the deal and compensate by paying damages (Holmes 1920 at p. 175).

<sup>5</sup> The rivalry of the two camps has also been termed as "property vs. liability rule", "legality vs. efficiency view", "rule vs. efficiency orientation" or "contract vs. treaty view" (Charnovitz 2001, pp. 802, Lawrence 2003, chapter 2). We prefer the dichotomy compliance/rebalancing, because the two terms signify targeted objectives, and not just the means sought for reaching the respective ends.

<sup>6</sup> The compliance-rebalancing controversy has essentially been led by Anderson (2002) Bello (1996), Sykes (2000), Bown (2002), Palmetier and Alexandrov (2002), Schwartz and Sykes (2002) on the liability side, and by Jackson (1997b), Pauwelyn (2000), Charnovitz (2001; 2002c; 2002a), Jackson (2004), Nzelibe (2005), Pauwelyn (2005) on the property-rule side of the debate. Numerous other papers allude to the debate but do not add substantial insights.

analyzed: The scope and dimensions of the compliance/rebalancing cleavage will become apparent.<sup>7</sup>

## **2.2 The rebalancing school of thought**

In a nutshell, the rebalancing camp basically views the objective of dispute settlement as supplying an insured safety-valve for injurers in a non-stationary world. By equilibrating the mutual balance of concessions, DSU enforcement mechanisms ensure the twin-goal of compensating the victim and of providing the injurer with an efficient opt-out possibility.

### **2.2.1 Theoretical foundations of the rebalancing approach**

The theoretic foundations of the rebalancing camp tend to originate from the disciplines of trade economics, law & economics (L&E), and the international political economy branch of international relations. They are highly influenced by economic logic and the paradigm of rational choice.<sup>8</sup>

The rebalancing argumentation is rooted in the conviction that the world trading system is fundamentally driven by reciprocal promises of trade liberalization and market access which give rise to a “balance of market access concessions”.<sup>9</sup> According to the rebalancing logic, the essence of the WTO – just like the preceding GATT – is a mutual exchange of market access opportunities that WTO Members grant each other. The basic intuition guiding much of the literature is that countries cooperate in trade matters in an effort to constrain unilateral “beggar-thy-neighbor” policies.<sup>10</sup> Trade protection, i.e. a unilateral reduction of market access, benefits the mercantilist or general-welfare objectives of an enacting country; however, doing so may reduce the welfare of trading partners. Trade protection provokes negative externalities, or spill-overs.<sup>11</sup> The strategic set-up of a prisoners’ dilemma emerges: Excessive trade protection, albeit inefficient, becomes the dominant strategy for importing countries. The purpose of a trade agreement then is to eliminate

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<sup>7</sup> Please note that in this section we merely reproduce the argumentation of rebalancing and compliance schools. We do so without any judgment or critique of each perspective. A critical appraisal of the general trajectory of the debate and each of the two mindsets will ensue in section 3.

<sup>8</sup> For a legal explanation of rebalancing, see Dam (1970, pp. 357), Charnovitz (2001 at p. 801, 2002c, pp. 414), and Jackson (1997a at p. 60, 2004, p. 109). For an interpretation of the economic principles of rebalancing in dispute settlement, see Lawrence (2003, pp. 19), Bagwell and Staiger (2002, pp. 58, 104), Ethier (2001, p. 3), Rosendorff (2005, pp. 390), or Bown (2002, p. 288).

<sup>9</sup> The rebalancing view of the WTO is best described as “a system of reciprocal rights and obligations to be maintained in balance”, as Kenneth Dam notes (in: Charnovitz 2001, p. 802).

<sup>10</sup> See e.g. Johnson (1953), Dixit (1987), Bagwell and Staiger (1990; 1999; 2002), Bagwell *et al.* (2002), Ethier (2004; 2006). Confer WTO (2007, chapter II.B) for a comprehensive overview of rationale for trade contracts.

<sup>11</sup> A government is assumed to set its import barriers with the aim of maximizing its welfare, while recognizing that some of the cost of this market-closing measure will fall upon foreign exporters whose products sell less in the domestic market. This basic insight leads *all* rational governments to set unilateral trade barriers higher than what would be globally efficient.

these inefficient restrictions on trade volumes. It offers governments a means to escape the prisoners' dilemma.<sup>12</sup> Mutual market access concessions are the currency of that trade deal.<sup>13</sup>

According to "rebalancers" the WTO is thus best conceptualized as a web of bilateral market access contracts (Lawrence 2003, chapter 2) or "packages of bilateral equilibria" (Pauwelyn 2000 at p. 340). Rational bargaining by Member governments now mandates that in the initial trade negotiations market access concessions be granted on a *reciprocal* basis, creating the balance of concessions.<sup>14</sup>

The role of enforcement of WTO obligations is tantamount to achieving a *re*-balancing of commitment levels in case the original equilibrium of concessions is out of synch: The initial "balance of benefits and burdens contemplated in the covered agreements vis-à-vis other Members" (Vazquez and Jackson 2002, p. 563) as the core of the trade accord should be defended against any kind of *ex-post* backtracking policy on the part of any signatory. Backtracking, or partial renegeing of initially granted concessions, can take any form whatsoever: It can be voluntary or accidental, open or concealed, formal or informal, temporary or permanent. *Form* notwithstanding, its *substance*, namely a partial denial of initially granted market access, stays the same and needs to be made up for: Whenever the initial balance of concessions is in disequilibrium, it "nullifies or impairs" advantages previously promised to the victim Member. In such circumstances, contracting parties undertake efforts to restore the equipoise of initially conceded economic advantages and must bring the balance back into equilibrium (hence: *re*-balancing).<sup>15</sup>

The general techniques for achieving rebalancing vary: Negotiation and out-of-court settlements, withdrawal of the offending measure by the injurer, alternative offers of compensation in sectors other than the one in question, or "suspension of concessions or other obligations", enacted by the

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<sup>12</sup> The essence of a prisoners' dilemma is the ranking of payoffs in a game between two players (here: countries). Assume two countries, where each may take two possible courses of action (e.g. Axelrod, 1984): Let *C* denote cooperative behavior by the *home* country and *D* is the home country defecting (*C*\* and *D*\* are the foreign country's action set). *Home*'s ranking of pay-offs is  $DC^* > CC^* > DD^* > CD^*$ . *Foreign*'s ranking is the symmetrical opposite ( $CD^* > CC^* > DD^* > DC^*$ ). Applied to the international "trade game", this means that each side would prefer to enact protectionist policies, provided the other side complies, because such beggar-thy-neighbor actions would yield opportunistic gains to each country. Mutual cooperation is preferred to mutual defection. The worst outcome is compliance when the other party defects. If the game is played once, both parties will choose to defect for fear of being deviated against and suffering the "sucker's payoff" –  $DD^*$  is the inevitable outcome. *Home* and *Foreign*, however, realize that by concluding a trade contract, both players can simultaneously propel their payoffs to a higher level, the  $CC^*$  outcome.

<sup>13</sup> Trade concessions can take various forms: compulsory tariff bindings (Art. II GATT), positive GATS concessions in the four service modes, codes of conduct of how to deal with non-tariff barriers ("Agreement on Technical Barriers to Trade", or the "Agreement on Sanitary and Phytosanitary Measures" are examples), with non-discrimination stipulations (e.g. Art. I and III GATT), with a prohibition of quantitative restrictions (Art. XI) and others.

<sup>14</sup> According to Finger and Winters (2002, pp. 50) reciprocity has been the motivating principle of the GATT/WTO system (on that note see also Bagwell and Staiger 1999, 2002, chapter 4).

<sup>15</sup> "The objective [of enforcement], therefore, is not to penalize a breach of the rules. It is to resotre, with the minimum interference with trade, the balance of concessions and advantage between the parties in dispute." (Long 1985, p. 76, see also Dam 1970, pp. 79)



victim, are all possible rebalancing instruments.<sup>16</sup> Suspension of concessions, also known as “tariff retaliation” or “sanctions”, features prominently due to its undeniable advantage of being self-enforceable by the affected victim. When retaliating, two pitfalls must be avoided: For one, the victim Member should not be allowed to react with overzealous retaliation (Schwartz and Sykes 2002). Second, the injuring Member should not be permitted to hitch a free ride by escaping its compensation duty or endurance of retaliation. The magnitude of compensation and retaliation is logically limited to being strictly *commensurate* to the damage caused by the “imbalancing” act.<sup>17</sup> This “proportionality principle” (Ethier 2001) renders punitive damages logically incompatible. WTO arbitrators, when calculating their nullification and impairment awards, must interpret the “equivalence standard” of Art. 22.4 DSU strictly in light of this rebalancing logic.<sup>18</sup>

Drawing analogies to economic theories of private commercial contracts, some WTO scholars have gone one step further: Bello (1996), Sykes (2000), Schwartz and Sykes (2002), Hauser and Roitinger (2003), Dunoff and Trachtman (1999), and Trachtman (2006) claim that the purpose of WTO DS goes well beyond securing a passive rebalancing. Rather than serving as a mere insurance mechanism for potential *victims*, dispute procedures also support *injuring* parties, whenever some unexpected external shock disturbs the initial balance of market access concessions. As these authors contend, the DSU facilitates (and protects) escape from contractual obligations in situations where standard provisions of escape are inadequate or insufficient in ensuring efficient adjustment to changing circumstances (Sykes 2000, p. 348, Schwartz and Sykes 2002, section III).<sup>19</sup> The WTO is understood as an incomplete contract that can neither explicitly take into consideration the complexities of the relationship between Members, nor anticipate all future states of the world (“contingencies”). Performance strictly according to the (rather limited) letter of the treaty is not always jointly beneficial when circumstances change. Siding with common wisdom of incomplete contract theory (cf. Shavell 1980, Posner 1988, Mahoney 1999, Masten 1999), rebalancers maintain that in a non-stationary world contractual performance is apposite whenever the gains of non-performance outweigh the damage that such behavior entails for the victim party.

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<sup>16</sup> As with like any ordinary balance, equilibrium can be restored either by removing weight on one side (i.e. the injuring party withdraws the initial measure, or offers compensation in return for nullification and impairment), or by adding weight on the other side (i.e. the violated party reciprocates with enacting retaliation measures). See also Pauwelyn (2000 at pp. 320).

<sup>17</sup> Although *permanent* compensation is not permitted *de iure*, rebalancing proponents argue that it is *de facto* a possibility: Contracting parties just come to a mutually accepted agreement and drop the dispute.

<sup>18</sup> For rebalancers, the inception of the WTO DSM substantially improved the old GATT rules for settling disputes, but did not alter the fundamental logic of the bilaterally negotiated bargain among sovereign states: They maintain that the inception of the DSU into the framework of the WTO treaty constituted an antidote to the procedural deficiencies of Arts. XXII and XXIII of the GATT – but did not change its deeper logic (Schwartz and Sykes 2002, Hauser and Roitinger 2003). To them, the DSU mainly codified the evolution of GATT trade dispute practice from the “1979 Understanding Regarding Notification, Consultation, Dispute Settlement and Surveillance” to the “Montreal Rules” from 1989 (Mavroidis 2000, p. 777). As in GATT times, the proceedings of the new WTO dispute settlement are neatly embedded into the wider systemic logic permeating trade agreements. Trade disputes – be they under GATT 1947 or WTO – are indicative of the fact that original market access balance is out of synch. Enforcement measures and instruments under the WTO DSU now have to safeguard that proper rebalancing occurs.

<sup>19</sup> Such standard provisions for *ex post* escape are those on renegotiation of tariff bindings or GATS concessions (Arts. XXVIII GATT and XXI GATS, respectively), or so-called contingency measures for deviation under specified conditions (e.g. Arts. XIV, XIX, XX, XXI, GATT).

The strict rebalancing requirement of the DSU now fulfills a dual role and solves Ethier's "reciprocal-conflict problem":<sup>20</sup> On the one hand commensurate punishment compensates the victim of a backtracking measure (and thereby formally insures it against any *ex post* escape). On the other hand, the requirement of substantial equivalence of the countermeasure to the damage done allows the injuring party to make use of the DSU as a ready-to-use *safety valve*, without being punished by exorbitant sanctions on the part of the victim. This dual role of the rebalancing principle in essence ensures that rational parties use their discretion *only* in situations where flexible adjustment to outdated contractual modalities is Pareto-efficient (Ethier 2001, Rosendorff and Milner 2001, Bagwell and Staiger 2002, chapter 6, Rosendorff 2005, Mahlstein and Schropp 2007).<sup>21</sup> Whenever compensated opt-out is jointly preferred, the conditions for "efficient breach" are met.<sup>22</sup> Flexible adaptation to changing circumstances is then mutually beneficial and every opportunity to do so will be seized.<sup>23</sup>

### 2.2.2 *De iure support for the rebalancing view*

So much for the theoretical underpinning of Bello's original contention that "compliance with the WTO, as interpreted through dispute settlement panels, remains elective [...] A government can change its mind and raise a particular tariff, provided it offsets such nullification and impairment of the delicate GATT balance through compensatory tariff reductions" (1996, p. 417). Sykes (2000) and Schwartz and Sykes (2002) have made efforts to demonstrate that the treaty language

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<sup>20</sup> Ethier (2001, p. 5) describes the *reciprocal-conflict problem* as follows:

"Each country is aware, *ex ante*, that it may find itself, *ex post*, harmed by a policy that some trading partner wishes to make. So the former will want a recognized punishment procedure as a deterrent. But that country will also be aware, *ex ante*, that it might find, *ex post*, itself in a position where it would be costly not to take some policy action that would harm a partner. This is the *reciprocal-conflict problem*: Every country knows that it might turn out to be either the accuser or the accused. Thus it is in no country's best interest, *ex ante*, to agree that, *ex post*, either the accuser should be unconstrained in its ability to punish or the accused should be unconstrained in its ability to proceed without punishment" (emphases in original).

<sup>21</sup> For rebalancing proponents a growing use of the DSM and the countermeasure of retaliation is a sign of a system at work – not at fault (WTO 2007, section II.D.3). The DSU mechanism is the quasi-legal opt-out that countries need in order to react appropriately to the ever-changing realities of world trade. For them, the clamor about rising non-compliance or a spiraling into "trade wars" is in fact a non-issue, since tariff retaliations are proof of a functioning system of flexibility (Hauser and Roitinger 2003).

<sup>22</sup> The "efficient breach" hypothesis, as formulated by contemporary WTO commentators, can be summarized as follows: "There are circumstances where breach [read: unilateral opt-out] of contract is more efficient [for the general welfare of contracting parties] than performance, and the law ought to facilitate breach in such circumstances" (Dunoff and Trachtman 1999, p. 31). "According to the concept of 'efficient breach' [...] a contract breach allows the breaching party to pay damages to redress the harm (loss of profit, etc.) without performing its obligations under the contract. In most cases, the nonbreaching party will be made 'whole' and, in some cases, even better-off. Thus, the breaching party has the option of refusing further performance if its compensation fully protects the nonbreaching party's reasonable economic expectations from performance of the contract" (Jackson 2004, p. 122).

<sup>23</sup> The proportionality principle cherished by rebalancers would explain why WTO sanctions under Art. 22.4 DSU (just like sanctions under the preceding GATT) are so "toothless" in nature. For Schwartz and Sykes (2002 section IV.B at p. 26) the main innovation of the DSU was the institutionalization of the "efficient breach" principle: "[T]he innovation of the DSU was intended not so much to deter violation of most substantive rules [...] What the system really adds is the opportunity for the losing disputant to 'buy out' of the violation at a price set by an arbitrator who has examined carefully the question of what sanctions are substantially equivalent to the harm done by the violation [...] The new system does a better job of protecting violators from the actual or threatened imposition of excessive sanctions. In turn, it ought to perform better than the old system at ensuring that opportunities for efficient breach are not undermined."

of the DSU in its present form can effectively be interpreted in a way consistent with the Holmesian pay-or-perform system: According to Schwartz and Sykes, the letter of the DSU – mainly DSU Arts. 3.7, 19.1, 22.1, and 22.4 – allows a potential injurer to unilaterally opt out of, or escape, *any* treaty obligation, as long as the victim of the measure gets compensated for the level of nullification and impairment it sustained through the measure in question (cf. Sykes 2000, pp. 349). In other words, the authors maintain that the WTO treaty provides for a general and unconditional *de iure* liability rule of flexibility. This would imply that every contingency laid down in the Agreement can be reneged upon, and that every contractual gap can be seized by the injurer – given the victim’s level of expectancy is preserved.<sup>24</sup>

The existence of non-violation complaints (Art. XXIII.1b GATT and Art. 26 DSU) and conceptual similarity between violation- and non-violation complaints allegedly weighs heavily in the favor of rebalancing proponents (e.g. Bagwell 2007, Bagwell and Staiger 2002): The victim – agnostic as to how the initial level of market access was brought in imbalance – may always unilaterally re-establish the balance of concessions by engaging in tariff retaliation.<sup>25</sup>

In summary, rebalancers are under the presumption of a general liability rule of trade policy flexibility in the WTO. *All* opt-out behavior is permissible and covered in the terms of the Agreement – by virtue of a very liberal DSU. Ultimately, this seems to suggest that *no extra-contractual behavior exists*. The DSU as a legitimate tool for non-performance “internalizes” all sorts of reneging behavior. Contractual escape coupled with indemnity (damages payments) *is part of the rules*.

### **2.3 The compliance school of thought**

The compliance school of thought takes an entirely different perspective on the object and purpose of WTO enforcement and on the role of dispute settlement procedures. Compliance advocates submit that not rebalancing, but inducing ongoing and strict compliance with the explicit terms of the Agreement is the key objective of WTO dispute settlement. The legal effect of an adopted panel report, they contend, is the international legal obligation to adhere to the panel/AB rulings. WTO enforcement mechanisms are to deter future violations for the sake of legal predictability and stability of the global trading system. Compliance proponents point to theoretical and legal arguments to back up their contentions.

#### **2.3.1 Theoretical foundations of the compliance approach**

As mentioned in subsection 2.2, the rebalancing camp borrows extensively from international economics and the economic theory of private contracts to buttress its theory. The compliance

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<sup>24</sup> Termed differently, for rebalancers the DSU (rather: *violation-cum-retaliation*) is the *de iure* default or fallback mechanism of trade policy flexibility in the WTO, which kicks in whenever unanticipated circumstances occur. Although the DSU procedures are conceptually similar to other treaty provisions (e.g. GATT Arts. XIX or XXVIII), the latter are limited in their application scope by the hefty conditionality laid out in the text of the articles (Schwartz and Sykes 2002, section II).

<sup>25</sup> “The idea underlying [Article XXIII:1(b)] is that the improved competitive opportunities that can legitimately be expected from a tariff concession can be frustrated not only by measures proscribed by the General Agreement but also by measures consistent with that Agreement. In order to encourage contracting parties to make tariff concessions, they must therefore be given a right of redress when a reciprocal concession is impaired by another contracting party as a result of the application of any measure, whether or not it conflicts with the General Agreement“ (GATT Panel report on *EEC – Oilseeds* at § 144).

school of thought, on its part, is deeply rooted in the discipline of public international law (henceforth PIL). For international lawyers it is the treaty text that sets the parameters of Member conduct. In support of their argument compliance scholars rely mainly on textual evidence and on other standard legal treaty interpretation techniques, such as subsequent practice, interpretation of the treaty by panels, AB and trade practitioners, drafters' intent (preparatory notes), and context of the object and purpose of the treaty.

According to compliance theorists, the rules of the game in the world trading system have changed decisively with the inception of the WTO in 1995. Whereas the GATT 1947 was more of a negotiation forum characterized by power politics and diplomacy, the modern-day WTO represents a rule-oriented international economic regime guided by strong underlying norms and sets of shared values. The trade liberalization negotiations of the Uruguay Round, which led to an explosion of additional rules and obligations (think of various new Agreements, such as the SPS, TBT, GPA, ROO, SCM, ADA, SGA and of course the DSU<sup>26</sup>). This drive to completing the contract is interpreted as a paradigm shift away from reciprocity and rebalancing, and towards a fully legalized "trade constitution".<sup>27</sup> "This gravitation of the whole system toward rules suggests that rebalancing has less and less of a role to play in the WTO context" (Jackson 2004, p. 121; see also Pauwelyn 2000, Charnovitz 2001; 2002c).

Compliance advocates contend that the fundamental values and objectives cherished by the "new" WTO are not (or no longer) narrow state interests, but *stability* and *predictability* of the world trading system (as instructed by Art. XVI of the Marrakech Agreement and Art. 3.2 DSU). The aim of the WTO is to protect the expectations and competitive relationships of *all* economic agents, including traders and commercial entities, consumers, civil society and uninvolved third party governments (Charnovitz 2001). This, so compliance backers claim, presupposes a creditable, objective and apolitical dispute settlement instance that redresses power asymmetries, and effectively levels the playing field between powerful states and weaker ones. Aspects of rebalancing or "efficient breach" in this connection are neither "central [n]or even operative in the normal DS processes" (Jackson 2004, p. 118). Active rebalancing in the form of tariff retaliation or compensation may even be counter-productive in that it undermines the longer-range goals of legal security and predictability. These goals can be ensured only by constant application of the rules and by binding third-party arbitration. "This feature is important to every type of juridical system, whether national or international" (*ibid.*).

In addition to a systemic, WTO-intrinsic, argumentation of the positive effect of binding panel reports, compliance advocates resort to the tenets of PIL. The WTO, compliance advocates claim, is not a self-contained regime that exists in isolation, but is fundamentally rooted in the grander scheme of international law, as the very first AB report made clear.<sup>28</sup> A dispute panel's recommendation (which is quasi-automatically adopted by the DSB thanks to the reverse

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<sup>26</sup> The acronyms stand for "Agreement on Sanitary and Phytosanitary Measures", "Agreement on Technical Barriers to Trade", "Agreement on Government Procurement", "Agreement on Rules of Origin", "Agreement on Subsidies and Countervailing Measures", "Antidumping Agreement", and "Safeguards Agreement", respectively.

<sup>27</sup> Charnovitz (2001, 2002c, 2002a), among other commentators, reports a gradual move from a "cloak-and-dagger" diplomatic bargaining forum under the GATT (1947-94) towards an international rule-of-law system with shared norms and values in the WTO. The drive towards a stronger rule-of-law has also been termed "rule-orientation" (as opposed to "power-orientation, see Jackson 1997a at pp. 109, Bagwell and Staiger 2002, pp. 5 and 36, Roitinger 2004, p. 143).

<sup>28</sup> *US – Gasoline*, informally known as the *Superfund* case (WT/DS 2 and 4, at §17).

consensus rule) is a court-ordered sentence just like in any domestic or international context. A Member condemned for having violated a WTO Agreement is infringing upon its obligations under PIL. Such Member has the international legal duty to comply with dispute settlement rulings (Jackson 1997a; 1997b, Mavroidis 2000, Grané 2001, Jackson 2004). To compliance advocates, disregarding a court's ruling is the same as disregarding the rule itself. There is no option of deviating from this court-ordered international legal obligation – everything else would make a mockery of the court and take the concept of law *ad absurdum*. If a party to the treaty were permitted to disobey the commonly agreed-upon rules and procedures, the entire system of law would be futile.<sup>29</sup> Opting out by refusing to comply with a conviction brought forth by an international adjudicating body is an abhorrent thought to international lawyers.

The compliance view concurs with rebalancing proponents that the WTO is indeed an incomplete contract in a non-stationary, dynamic environment (see Sykes 2000, p. 347). However, it fundamentally disagrees with the rebalancing school as to the manner in which efficient *ex post* adjustment is to take place. Whereas under the precepts of a rebalancing system an injurer can adapt to changing circumstances unilaterally by choosing a liability rule-type *violation-cum-retaliation* strategy, compliance advocates beg to differ. A party wishing to change or modify the agreed-upon terms of the multilateral trade accord should engage in an attempt to negotiate with the concerned party/parties a release from performance. This view of WTO enforcement is analogous to a “property rule” of entitlement protection.<sup>30</sup> The requesting party can avoid its contractual commitments in some industry (or issue area) only if it manages to secure permission from the affected Member(s), usually by offering tariff compensation in other sectors. No backtracking measure can be enacted against the consent of the victim, or else PIL is violated.

Concretely this means that using the DSB as a safety-valve for *ex post* escape it out of the question.<sup>31</sup> For compliance advocates the only permissible manner of reacting to unforeseen developments and of withdrawing previously made trade concessions is to happen via renegotiations under the purview of provisions like Art. XXVIII GATT, Art. XXI GATS, or Art. X of the Marrakech Agreement.<sup>32</sup> “But [despite the possibility to withdraw from previously made concessions,] the ultimate idea that full compliance is an international law obligation can still be crucial to the notion of a rule-oriented system that is objective and credible and provides for a basis of security and predictability for all members of the organization, as well as non-governmental beneficiaries of the system” (Jackson 2004, p. 122).

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<sup>29</sup> DSB rulings are hence international legal obligations *erga omnes partes* liable to the community of Members, and not just owed bilaterally (Pauwelyn 2001). Panel recommendations are public goods and not just a matter of concern to the disputing states – not only due to the precedence they set, but more so for the legal stability of rules they ascertain (Jackson 2004, pp. 120).

<sup>30</sup> Under a property rule of entitlement protection all signatories are under a strict obligation to respect the initial entitlement distribution. However, a requesting party (the taker) can buy off the entitlement holder's right through *renegotiations*. The taker can thus avoid its commitments by securing permission from the concerned party (or owner) – usually by paying a bargained amount.

<sup>31</sup> Compliance advocates warn against interpreting *violation-cum-retaliation* as a contractual safeguard, stating that the two concepts – legally and logically – are separate issues (Charnovitz 2001, p. 818). Jackson (2004, p. 121) states that the two concepts of safeguards and dispute settlement were distinctly separated in the GATT drafting process, and that four decades of history caused dispute settlement to evolve rather consistently and persistently towards a more juridical, rigorous, and creditable system.

<sup>32</sup> Compliance activists acknowledge the presence of certain contractual liability-type contingency measures in the WTO such as Arts. XIV, XIX, XX, XXI, GATT, but note that the right to opt out unilaterally is circumscribed *exhaustively* in these provisions, and is additionally confined by Art. 3.4 DSU (“mutually agreed solutions have to be consistent with the obligations of the covered agreements”).

Treaty enforcement plays an integral role in the compliance system. Since every party is contractually obliged to perform according to its previously made trade liberalization concessions, any *extra-contractual* behavior in contravention to this strict specific performance duty must be sanctioned rigorously (Mavroidis 2000, p. 811). Punitive damages in the form of penal *trade sanctions* (in the original sense of the word) are not alien to this perspective – although the letter of Art. 22.4 DSU presently forestalls this option.<sup>33</sup> Nevertheless, *extra-contractual* remedies are to be *interpreted* as penalties intended to coerce recalcitrant violators into obedience, and to deter all WTO Members from future defections (cf. Sykes 2000, p. 351, Jürgensen 2005). Hence, a link between court-ordered remedies on the one hand, and the actual trade damage caused by an injuring act on the other hand, is a necessity *only* by virtue of the limitations of Art. 22.4 DSU – not due to systemic logic.<sup>34</sup>

In order to improve on the efficiency of the system, compliance activists advise Members to decouple WTO remedies from the amount of damages suffered. Punitive damages, monetary fines and other collective penalties are perfectly acceptable in principle, since they disincentivize WTO-inconsistent behavior and induce compliance.<sup>35</sup> All incentives to adapt to changing circumstances would then be channeled through the mechanism of mutual consent and renegotiation.

### **2.3.2 *De iure* support for the compliance view**

In order to support their contention that the WTO features a *de iure* compliance obligation, compliance proponents resort to textually oriented legal interpretation techniques (Jackson 2004, p. 111). In so doing, they see no textual and international legal leeway for anything but a general rule of unquestioning specific performance, i.e. strict compliance with the letter of the law. If a contractual gap appears in the course of the conduct of the WTO treaty, or if one party is significantly unhappy with either the concessions promised, or with pertinent passages of the treaty text, it is the respective Member's duty to engage in formal, constructive renegotiations. WTO lawyers of the compliance camp point to numerous passages in the WTO DSU, Preamble and text of the Marrakech Agreement (the WTO "Charter"), preparatory notes, and various panel and AB reports. Charnovitz (2001, 2002c) sets out on meticulous quest to find evidence for a strict compliance objective of WTO enforcement. In support of his argument, the author extensively cites official WTO documents, GATT and WTO negotiating history, statements from trade practitioners, and assertions of learned scholars (see also Pauwelyn 2000 and Jackson 2004 for extensive lists of panel/AB reports in support of the international legal bindingness of WTO rules and rulings).

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<sup>33</sup> Article 22.4 DSU reads: "The level of the suspension of concessions or other obligations authorized by the DSB shall be *equivalent* to the level of the nullification or impairment", while Art 4.10 SCM states that "the DSB shall grant authorization to the complaining Member to take *appropriate* countermeasures" (emphases added). WTO arbitrators interpreted the SCM's *appropriateness* standard to bear a much more punitive character than the *equivalence* standard (see Lawrence 2003, chapter 4, Sebastian 2007).

<sup>34</sup> Grané (2001, p. 763) notes: "Even if we accepted that both compensation and withdrawal of concessions were originally conceived as counterbalancing actions or re-balancing of trade concessions, whose objective was to reestablish the lost balance of rights and obligations, they are *nowadays* perceived in practice as sanctions or punitive measures for failure to comply with the adopted recommendations of the DSB. At best, they are considered means to induce compliance" (emphasis added).

<sup>35</sup> See Mavroidis (2000), Pauwelyn (2000), Charnovitz (2001), WTO (2004), Bronckers and van den Broek (2005).

In summary, in the current controversy over purpose and objective of WTO enforcement, and the bindingness of panel/AB reports, WTO scholarship up to this very day is divided into two opposing camps. Both schools of thought acknowledge the incompleteness of the WTO contract. The rebalancing camp, on the one hand, views WTO enforcement and DSB procedures as a general liability rule of unilateral opt-out geared towards providing an insured safety-valve in a non-stationary world. The DSB rules and procedures are to achieve the twin goal of compensating the victim and providing the injurer with an efficient opt-out possibility. The compliance faction of WTO scholarship, on the other hand, contends that WTO enforcement is to induce compliance with panel/AB rulings, with the aim to foster predictability and stability vis-à-vis *all* economic agents and to deter future infringements of the Agreement (and therewith of international law). The WTO, it is argued, is protected against protectionist backtracking by a general property rule, and backed by the strong enforcement belt of unambiguous language in the DSU.

### 3 An appraisal of the rebalancing and the compliance approach

The compliance/rebalancing controversy seems to have hit a dead-end. The conflict between the two perspectives has been described as a “*discours des sourds*” (discourse among deaf-mutes) by Hauser and Roitinger (2004, p. 641) for good reason: Although the controversy should have stimulated closer occupation with the other camp’s underlying assumptions, authors on both sides of the divide just seem to have busied themselves with deepening the trenches. They continued promoting their respective perceptions and methodologies, mainly without considering alternative explanations of DSU objectives.<sup>36</sup> The fault lines between economic logic of rebalancers and legalistic thinking of compliance advocates seem unbridgeable: Whereas the former point to the *realpolitik* of Members’ *de facto* opt-out behavior in support of their thesis (as the disputes *EC – Hormones*, *EC – Bananas*, *US – FSC*, or *US – Byrd*, or *US – Gambling*<sup>37</sup> seem to confirm), the latter find it hard to fathom that anybody seriously challenges the literal bindingness of international legal obligations.

Some commentators have tagged this scholarly controversy as “insignificant” or “minor”.<sup>38</sup> Belittlement may be a practical way of dealing with certain problems in order to return to “business as usual”. It is, however, not a proper solution to what effectively is a fundamental issue. One should examine in more detail why the compliance/rebalancing controversy failed to gather enough momentum to reach a solution, and why the debate unresolved is as ever. In this section and the next we look for possible answers to these questions. Subsections 3.1 and 3.2 will examine various flaws and inconsistencies in connection with the rebalancing and compliance school of thought separately. Section 4 will take issue with the manner in which the discussion was framed.

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<sup>36</sup> The latest “rebalancing” contributions include Josling (2004), Bagwell (2007), Rosendorff (2005), Bagwell and Staiger (2005a), Howse and Staiger (2005), Herzing (2005), Yerxa (2005), Kohler (Kohler 2004) and Bown (2004). Recent compliance pieces include McGivern (2002), McLean (2002), Movsesian (2003), Petersmann (2003), Bronckers and van den Broek (2005), Jürgensen (2005).

<sup>37</sup> DS 26, 48; 16, 27; 108; 217; 285, respectively.

<sup>38</sup> A WTO Appellate Body Member in personal communication with the author referred to the compliance/rebalancing debate as a “storm in a teacup”. But see recent contributions that exactly stress the importance of this question (Lawrence 2003, Araki 2004, Pauwelyn 2005, Sebastian 2007).

We will demonstrate that WTO *enforcement* is the wrong bone of contention and that WTO scholarship would be well-advised to concentrate on a much broader issue, namely the nature of the WTO contract proper.

### 3.1 A critique of the rebalancing perspective

The rebalancing approach to the WTO contract is subject to two serious and consequential shortcomings: (i) A confusion of reality and ideal, and (ii) a-contextualism. We explain each in turn.

First, rebalancing advocates run the risk of confusing the actual *as-is state* of the WTO contract with an ideal *should-be state*. Some rebalancers contend that the letter of the WTO treaty actually supports their rebalancing contention. However, a liability interpretation of the WTO is textually untenable.

As a matter of positive law, a liability-type pay-or-perform permission is absent in the wording of the DSU. Sykes (2000), and Schwartz and Sykes (2002) interpret various passages in the DSU (Arts. 3.7, 19.1, 21.1, 22.1, 22.8, 26.1.b) in a way that allegedly supports their liability-rule hypothesis. Each of the passages therein, they claim, can be read in a way consistent with a Holmesian liability system of flexibility. Their argumentation is creative, but ultimately far-fetched. The letter of the text unambiguously states that WTO recommendations are binding, and that compliance with the obligations of the treaty is mandated for. An attentive reading of Arts. 21.1, 22.1 and 22.8 DSU alone should dispel doubts that specific performance is the compulsory conduct.<sup>39</sup> In contrast to legal mechanisms of flexibility, such as Arts. XIX and XXVIII GATT which permit a liability-type escape, the DSU does not contain a pay-or-perform option. Mutually agreed solutions following a panel/AB report may be *negotiated* between potential injurer and

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<sup>39</sup> Pertinent passages in the DSU read (emphases added): “Prompt *compliance* with recommendations or rulings of the DSB *is essential* in order to secure effective resolution of disputes” (Art. 21.1); “the suspension of concessions or other obligations shall be *temporary* and shall only be applied until such time as the measure found to be inconsistent with a covered agreement has been removed, or the Member that *must* implement recommendations or rulings provides a solution to the nullification or impairment of benefits, or a mutually satisfactory solution is reached” (Art. 22.8); “compensation and the suspension of concessions or other obligations are *temporary* measures available in the event that the recommendations and rulings are not implemented within a reasonable period of time. However, 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” (Art. 22.1). Note that counter to what Sykes (2000, p. 350) suggests, the word “preferred” in Art. 22.1 DSU relates to the term *temporary measures* in the preceding sentence, and must not be read in isolation. Therefore Sykes’ (*ibid.*) contention that “the text [in Art. 22.1 DSU does *not*] expressly say that [compensation and retaliation] are illegal or that a Member who elects compensation or retaliation is in violation of the rules” must be seen as wrong.



victim(s), but their enactment against the victim's will is prohibited.<sup>40</sup> Numerous panel and AB reports have interpreted the DSU to have exactly that compliance-inducing meaning.<sup>41</sup>

Let us engage in a thought experiment: Assume that the DSU-wording consented to by the treaty's founding fathers does not reflect what they had intended to contract for. Suppose alternatively that the framers of the WTO may have negotiated according to their intentions, but have written down a "bad" or "faulty" Agreement which fails to reflect what they would have opted for had they been more diligent, far-sighted, thoughtful, or under less time pressure. In both cases the DSU in its current form would have to be called flawed and in need of revision. However, this scenario is a completely new ballgame: It is a purely *theoretical* and not a *textual* argument, and one which presupposes a theory of the system, its players and their preferences, their negotiating constraints, market imperfections, etc. Analytical and systemic reasoning is a clear strength of the rebalancing approach. It draws analogies to strategic games, contract theory and to the economics literature. But this asset of possessing strong theoretical underpinnings is shadowed, arguably even foiled, by rebalancers' untenable and ultimately far-fetched textual exegesis.

To summarize, rebalancers are barking up the wrong tree when arguing what the DSU text *is, says* and *does*. They should better argue that they see it as a *systemic imperative* to (re-) organize the WTO along the lines of a liability rule-type system of trade policy flexibility. However, due to this omission, the rebalancing view risks forfeiting logical traction, losing credibility with a critic audience, and diverting attention from its real strength, which is sound contract-theoretical analysis and systemic rigor.

A second major flaw of the rebalancing perspective is its myopic view of the international world trading system. This view may result from an overzealous reliance on the results of formal contract theory and its models. In essence, rebalancing proponents adopt findings originating from contract theory in a reductionist and a-contextual manner. They tacitly insinuate assumptions which are not implied by standard contract theory, and that contract theorists cannot maintain, either. In turn, this may have lead to a misapplication of academic findings and a subsequent misinterpretation of the WTO Agreement.

Formal economic models of contractual relationships deal with extremely simplistic game settings, usually featuring two (but not 151) contracting parties, one traded entitlement (but not multiple), and often a complete set of actions, strategies and environmental contingencies (stationary

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<sup>40</sup> Mavroidis (2000, p. 800) notes: "Article 22(1) DSU makes it plain that both compensation and suspension of concessions are *not* preferred options to full implementation. In other words, a WTO member should not be presumed to be in compliance with its international obligations when it continues an illegal act and at the same time either it agrees to pay compensation or concessions in its favour are suspended. In such a case a WTO member continues an illegality and has not fulfilled its international obligations."

<sup>41</sup> Even assuming, *quod non*, that Schwartz and Sykes were right in their reading of the DSU, one could easily argue that customary international law or tacit consent among WTO Members has developed over the course of the last ten years which reflects dissent with the hypothetical treaty text. This international consent to the contrary would hence legitimize subsequent practice (Charnovitz 2001, Jackson 2004).

environment).<sup>42</sup> Reality is largely abstracted from, and the interaction is reduced to a theoretic bare-bone. Normally, the results and insights generated from various strands of contract theory do not easily carry over to just any desired contractual situation, but only to similar contracting contexts (see Schropp 2008, chapter 3.1.6). Whenever one is to implement and integrate findings of formal contract theory models, one must be very careful to adequately adapt them to the context at hand – here, the WTO. There is an inherent risk of losing explanatory scope, or, worse, generating wrong inferences by comparing the WTO to simple principal-agent or sales contracts.<sup>43</sup>

Ultimately, standard contract theory does not apply to the World Trade Organization. The WTO is much more complex and diverse a contract than anything formal contract theory usually deals with. Thus, results brought forth by formal contract theory have to be “customized”, adapted and reinterpreted to fit the WTO context. To that end, the contracting context has to be properly understood and sketched in the first place.

To our mind, proponents of the rebalancing camp have not heeded this principle. In particular, rebalancers adopt the insights generated from contract theory with regards to the “efficient breach” principle (see above footnote 22 and accompanying text): The literature on “efficient breach” is geared to address flexibility concerns with respect to *a single* entitlement. Yet, rebalancing proponents simply elevate “efficient breach”, or an unconditional liability rule of escape, as the lynchpin of WTO enforcement. In so doing, they generalize and misinterpret “efficient breach” as *a pars pro toto*. But this is fallacious: A contractual “efficient breach” *clause* is not tantamount to an invitation to opt out of *all* legal rights and obligations by means of an unconditional liability rule. In fact, an “efficient breach” *contract* is one in which every contractual entitlement is protected by that (set of) rule(s) which generates the most efficient outcome; it is the perfect governance structure that can be crafted in the presence of insurmountable contractual incompleteness (see Schropp 2008, 3.4.2).<sup>44</sup>

These two shortcomings combined entail a series of important implications which raise concerns as to the validity of the rebalancing view as *the* explanation for the object and purpose of WTO enforcement:

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<sup>42</sup> Contract theorists originating from the industrial organization discipline usually examine one-off sales transactions (future exchange of goods for money). Alternatively, they deal with principal-agent relationships such as that between an employee (who performs only a single task, or a well-defined set of simple tasks) and an employer. The contract then only consists of issues related to this task or set of tasks, and its remuneration. Other – more comprehensive – issues that we find in real employment contracts (multiple responsibilities, objectives, holidays, bonus packages, perquisites, unemployment and health aspects, training on the job, etc.) are neglected for the sake of formal tractability (cf. Masten 1999).

<sup>43</sup> Jackson (2004, pp. 111, 119), and Dunoff and Trachtman (1999, p. 19) warn of overstraining analogies from domestic private law jurisprudence and of incorporating them into the international law context, since parties of interest, institutional settings, and contextual circumstances are usually fundamentally different.

<sup>44</sup> An “efficient breach” *contract* is the one arrangement that mimics the outcome (but not the substance) of the hypothetical complete contingent contract, the unachievable contracting ideal for every agreement. A complete contingent contract is an Arrow-Debreu-type accord that completely informed, perfectly rational parties would write in absence of *any* contracting imperfection, such as negotiation costs, costs of information gathering, asymmetrical knowledge, or bounded rationality (e.g. Masten 1999, p. 27, Shavell 1980, Craswell 1999, Mahoney 1999).

### **1. Narrow scope of applicability: Exclusive focus on reciprocity-based rights and obligations.**

The rebalancing school of thought has its origins in economics. As was reviewed in section 2.2.1 above, for most economists the central objective of the WTO – indeed its very *raison d'être* – is a mutual exchange of market access (see text accompanying the footnotes 10-13). All rights and obligations traded in the WTO seem to be derived from this single substantive reciprocal commitment. Although we concur that the right to compete fairly in trade partners' markets is the most vital mutual obligation in the WTO, there seems to be confusion between *initial contractual entitlements* and the *rationale for the Agreement*. Rebalancing advocates are mistaken when equating the two: The WTO Agreement comprises of more exchanged rights and obligations than solely the market access entitlement.<sup>45</sup>

**2. No recipe for rebalancing of non-market access entitlements.** Rebalancing as a response to partial defection by one Member breaks down for unreciprocated, i.e. multilateral, entitlements. It is hard to see how rebalancing can be achieved in situations where positive, non-reciprocated commitments are infringed upon, such as procedural rules or minimum standard provisions:<sup>46</sup>

First, whenever a non-reciprocal treaty obligation is violated, the rebalancing approach has no *logical* remedial reaction in stock. Indeed, any “traditional” retaliatory response to a violation of a multilateral WTO obligations in the form of a retaliation or compensation exposes the liability-rule approach to a non-trivial puzzle: The victim's damage awards bring the initial balance of market access concessions into imbalance, and should – within the strict liability logic – allow the *original injurer* to retaliate so as to bring the market access disequilibrium into balance again. This logic easily leads to a downward spiral of trade wars.

Second, the rebalancing requirement poses non-trivial quantification problems for WTO arbitrators. How can the WTO arbitrator assess or calculate damages incurred by victims of *ex post* backtracking from multilateral obligations, when the harm caused lies in having negatively affected the entire trading system, and hence is very diffuse and hardly palpable? How can the membership assess the disutility caused by one Member infringing upon its obligation to, say, notify a policy instrument, to pay its Membership fees, or to have in place a functioning patent office? For WTO arbitrators calculating trade damages pursuant to an escape from a multilateral entitlement is hypothetical, next to impossible to apportion, and difficult to “monetize”:<sup>47</sup>

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<sup>45</sup> It is probably fair to say that the WTO Agreement with all its appending accords mentioned in Annexes 1-4 to the Marrakech Agreement is not solely about reciprocal market access and tariff reductions (see generally Pauwelyn 2006, Schropp 2008). Many more rights and obligations are being exchanged in the WTO, such as those concerning minimum standards (e.g. in the realms of intellectual property, investment or international standardization) or procedural guidelines (e.g. timelines, transparency obligations, notification requirements). More on that in section 5 *infra*.

<sup>46</sup> See Pauwelyn (2000, p. 342). Jackson (2004, pp.121) notes: “[H]ow does one quantify a breach of a DSU norm? Rebalancing in any objective and meaningful way seems to be a fallacy in the light of the shifting perspective of the GATT/WTO system away from more quantifiable norms, such as tariff norms, toward broader rules that should arguably be shaped so as to provide benefits to all sides, not just a reciprocal ‘swap’”.

<sup>47</sup> To see the logical and practical difficulties connected with the defection from a multilateral entitlement, consider the *Norway – Trondheim Toll Ring* case from 1991 (a GATT dispute). Norway failed to respect its transparency obligations under the GPA, because the municipal authorities in Trondheim assigned un-notified public works to a Norwegian company. This infringement of GPA transparency provisions may have led to damage. Yet, who was harmed by the measure and how to quantify such damages? Note that in principle *any* company operating in the relevant field and originating from a GPA signatory country could have won the contract bid. Hence, *any* supplier could have successfully litigated against Norway (cf. Mavroidis 1993).

Arbitrators would be charged with assessing how trade in the international trading system would have evolved had the escaping party performed as promised. In addition, they would also have to establish to what extent every single contracting party suffered as a result of the non-performance, and how the opt-out affected the competitive relationship between all signatories. Apart from the difficulty connected with the counterfactual nature of this calculation, the damage can be assumed to be profoundly *subjective* for every victim.<sup>48</sup> Finally, every systematic calculation error by the arbitrator is multiplied 150-fold in effect, since all of the 151 WTO Members (save the injurer) would receive the wrong expectation damage.

**3. No intellectual difference between contractual escape and dispute settlement.** Another serious consequence of the rebalancing view's myopic notion of dispute settlement is that it virtually grants no role to contractual enforcement: Under the rebalancing conception of the WTO as an accord of the reciprocal exchange of market access, virtually all instances of non-performance are legal. The need to sanction unlawful *extra*-contractual behavior by means of coercive countermeasures hence does not apply, since there only exist lawful – *intra*-contractual – pay-or-perform actions. This reductionist thinking suggests the following implications:

- The explanatory scope of contractual liability logically transcends the realm of the DSU. Using the *violation-cum-retaliation* strategy is just *one* of many complementary opt-out tools – albeit an important one. For rebalancing proponents the DSU procedures constitute *the* contractual *super*-rule of escape which surpasses *all* other legal norms. *Violation-cum-retaliation* constitutes an implicit contractual rule that permits the breach of all other rules – at any time and under any circumstances.<sup>49</sup> The fact that contractual opt-out mechanisms transcend the narrow realm of DSB rules/procedures has been largely ignored by rebalancing advocates in the compliance/rebalancing debate. It has, however, been recognized by some authors (e.g. Sykes 1991, Lawrence 2003, Roitinger 2004, Schropp 2005).<sup>50</sup>
- As a corollary, under the conception of a general liability rule of enforcement, dispute settlement is hardly about *disputes*. It is rather about facilitating contractual flexibility (or opt-out), and managing its consequences. A rebalancing regime is concerned with assessing and computing damages sustained by the victim of a measure in question. Hence, the main role of

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<sup>48</sup> Taking up the example from *Norway – Trondheim Toll Ring*: An arbitrator would have to calculate what the counterfactual level of world trade would have been, had Norway publicly tendered the construction work. This calculation should include general equilibrium considerations, second-order ripple effects, and third-party externalities. The arbitrator would also have to assign expectation damages to the U.S., Burkina Faso, Vanuatu and all other WTO\* Members and argue convincingly why the remedy amounts differ. Things get more difficult, if a defection from a multilateral entitlement does not cause palpable harm, but intangible damage: How can the subjective harm to Canada following, say, a refusal by the United States to pay the yearly financial contribution to the WTO be measured?

<sup>49</sup> This conception may have prompted Bello's to contend that "WTO rules are not 'binding' in the traditional sense" (1996, pp. 416).

<sup>50</sup> An interesting side remark is that rebalancing advocates cannot easily give meaning to the *existence* of non-violation claims under Art. 26 DSU (compare footnote 25 and accompanying text above): Questions of *violations* are out of the ambit of the simple rebalancing logic, therefore a distinction between violation- and non-violation claims is decrepit. For rebalancers, performance of WTO obligations is equivalent to ensuring market access. It is thereby irrelevant if non-performance occurs due to a violation- or pursuant to a non-violation claim.

the DSB panels and the AB is one of an arbitrator, information disseminator, conciliator, and monitor – but not that of an adjudicator.<sup>51</sup>

- The rebalancing school of thought has a hard time dealing with contractual ambiguity or imprecise language. Situations of ambivalence or ambiguity – possibly giving rise to “good-faith” clashes – are notably absent in this economic thinking. They are absent not because they don’t exist, but because they are assumed away from the outset (Masten 1999). In standard contract-theoretical models this does not matter all too much, because the types of contract that economic scholarship usually deals with are of an unambiguous nature. However, in more complex, long-term, repeated-interaction situations, such as the WTO, contractual ambiguity assumes a much more prominent role. The rebalancing approach to the WTO blindly adopts these results – stripping the DSB of any means to broker and adjudicate in good-faith clashes.
- The rebalancing approach largely ignores issues of *extra*-contractual behavior. The alleged liability system of entitlement protection mandates the implementation of commensurate damages in reaction to any instance of non-performance. Yet what happens in case of *extra*-contractual behavior? The simple system of pay-or-perform breaks down in various circumstances: Firstly, as just pointed out, it collapses in situations where some non-reciprocal obligation is infringed upon (cf. text around footnotes 47/48). Secondly, the rebalancing perspective on the WTO is overstrained if an injuring Member acts in bad faith and refuses to abide by the rebalancing rules of the game. Suppose one Member uses its “right” to opt-out to enact a protectionist measure. Yet assume that it neither offers voluntary damage payments (tariff concessions), nor accepts as legitimate the victim’s self-enforcement (tariff retaliation). Instead, the injuring Member engages in counter-retaliation. Without any rules of enforcement in place, the system is unable to sanction, let alone deter, such bad-faith behavior. Faced with non-compliant conduct (in the rebalancing logic), the choice under a self-enforcing regime then is between doing nothing and seeing the system lapse into a trade war spiral of retaliation and counter-retaliation. Thirdly, the rebalancing argumentation malfunctions in a situation where a weak victim lacks the economic power to engage meaningfully into retaliatory suspension of concessions.<sup>52</sup>

In conclusion, the rebalancing school of thought – incautiously or erroneously – equates contractual flexibility with enforcement rules and DSU procedures. When rebalancing advocates speak of *dispute settlement* and *enforcement*, they actually mean neither. In reality, they rather talk of contractual opt-out, calculation of damages, and payment of the contract-conform price for escape. The truth of the matter is: Rebalancers do not discuss contractual enforcement problems at

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<sup>51</sup> See Hungerford 1991, Ethier 2001, Ludema 2001, Rosendorff and Milner 2001, Rosendorff 2005, Thompson and Snidal 2005). Keck and Schropp 2007) provide for an overview of the roles of the DSB in trade economics.

<sup>52</sup> When facing a recalcitrant defendant, a weak complainant’s hope to achieve the declared objective of rebalancing will be frustrated. The rebalancing mindset thus depends on effective self-enforcement capacities by WTO Members. If a victim country does not have the economic (or political) power to inflict retaliatory damage on the injurer, the concept of “rebalancing” falters without provision of any fallback enforcement. Latin American trade diplomats perceptively noted that “trade sanctions are a huge club in the hands of industrial giants and a splinter in the hands of developing countries” (quote from Charnovitz 2001 at note 211, cf. also Palmetier 2000 at p. 472). Indeed, so far developing countries have never suspended concessions pursuant to an official arbitration award. In at least nine pertinent instances small countries won a trade dispute, but no action followed – neither compliance by large Members, nor a mutually agreed solution, nor retaliation. These cases are: DS 27, 122, 217, 241, 267, whereby co-complaints are counted as separate instances (see Horn and Mavroidis 2006a; 2006b).

all. Yet in real life, a rebalancing system cannot operate properly without enforcement strategies and mechanisms at hand. Unfortunately, proponents of the rebalancing paradigm have even “foreclosed” this avenue of true DSB enforcement by asserting that *violation-cum-retaliation* was just another pay-or-perform opt-out. The same goes largely for dealing with contractual ambiguity: Since rebalancing advocates interpret the DSB as a non-performance facilitation device, value-creating gap-filling and adjudication by panels/AB so as to clarify and interpret ambiguous language is out of the explanatory scope of the rebalancing approach to the WTO.

**4. Confusing terminology.** Rebalancing proponents utilize a baffling terminology. They utilize terms like “breach”, “violation”, “enforcement”, and “remedies” in a cooperative, *intra*-contractual context, since under the alleged general rule of liability, virtually *all* injuring behavior happens within the confines of the contract. This use of vocabulary, though occasionally championed in L&E literature on private and commercial contracts, is rather inappropriate in the context of public international law, where terms of this sort have a strict *extra*-contractual connotation, and are reserved for punishable deviations from previously agreed rules and regulations. The wording employed by liability advocates should be adapted to avoid disarray: The nomenclature “breach” or “violation” should be substituted by more neutral terms such as “non-performance”, “release”, or “excuse”. Likewise, “remedies”, “sanction”, or “countermeasures” should be properly termed “damage measure”, “indemnity”, or “price of non-performance”. “Enforcement”, finally, should read “implementation”.

**5. Limited explanatory scope: Rebalancing is a theory about concession-escape and market access-related gaps.** This point essentially summarizes all previous concerns. The rebalancing stance is *not* a full-scale theory of WTO enforcement. Rather, it is a theory about *market access-related performance gaps* and *efficient gap-filling*: A liability rule of entitlement protection works well in situations of unforeseen protectionist shocks and functioning (self-) enforcement. Under these circumstances contractual flexibility in the form of a pay-or-perform clause can possibly enhance the general welfare of all participating contractors. The rebalancing approach, however, cannot convince when faced with circumstances where *non-market access* rights and obligations are at stake. Non-reciprocated legal WTO entitlements are outside the explanatory ambit of the rebalancing logic. In the same vein, rebalancers stay mute on issues of *extra*-contractual behavior and ambiguous treaty language. By disregarding non-market access-related eventualities, instances of contractual ambiguity, and *extra*-contractual bad faith, rebalancing proponents have left too many questions unanswered.

To conclude our discussion on the shortcomings of the rebalancing perspective of WTO enforcement: A rather weak textual analysis of the positive law of the DSU raises serious doubts about the applicability of Art. 22 DSU as a generic liability-type tool of flexible contract adjustment. Credibility of valid conceptual and systemic considerations is gambled away by the rather bold contention that the WTO text actually supports this interpretation. In addition, the overzealous reliance on results of standard contract theory must raise doubts about the explanatory scope of the rebalancing mindset. As a result of these two major flaws, the rebalancing school of WTO enforcement reduces the multilateral trading system to a pared-down version of a mutual tariff-cutting agreement: When proponents of the rebalancing camp state that WTO *rules* are not binding in the traditional sense, they actually intend to say that previously negotiated *market access concessions* are not strictly binding, and are protected by an unconditional liability rule of

flexibility. This is a somewhat different ballgame, and a consequential qualification in scope of the applicability of the rebalancing perspective.

### 3.2 A critique of the compliance perspective

The compliance school of thought, too, has significant weaknesses. It is characterized by (i) heavy textual reliance, and (ii) the absence of both a noticeable systemic vision and a holistic perspective of the WTO contract.

First, the compliance school of thought overly relies on standard techniques of textual interpretation and legalistic analysis. In trying to reinforce their contentions that WTO enforcement is uniquely about inducing conformity with the letter of the law, proponents of the compliance perspective spend much effort on producing textual evidence as to what the treaty *says*, instead of engaging in a more analytical exercise of what the WTO originally was *conceptualized as*. To prop up their argument, compliance advocates engage heavily in textualism, ceaselessly quoting treaty texts (GATT, DSU, Marrakech Agreement, Preamble passages), preparatory notes, panel/AB reports, and statements by trade policymakers (see especially Charnovitz 2001, pp. 803, Jackson 2004, pp. 111). The compliance perspective fails to acknowledge that the core of the compliance/rebalancing dispute is fundamentally theoretical in nature and can hardly be solved directly by means of textual inference. Consider the following three points:

- For one thing, even John Jackson (1997b, p. 62, 2004, pp. 112) concedes that textual analysis does not manage to conclusively “nail down” the issue between the compliance and rebalancing camp, since the various WTO Agreements exhibit a good deal of textual imprecision and ambiguity. Even a WTO arbitrator (in *US – Byrd (Article 22.6)*, WT/DS217/ARB at para. 6.4) notes that “it is not completely clear what role is to be played by the suspension of obligations in the DSU”.<sup>53</sup>
- Second, contractual ambiguity is arguably best dealt with by resorting to the systemic logic of the contract, and not just by resorting to traditional legalistic treaty interpretation techniques, namely text, context, drafters’ intent, and practice under the Agreement. Teleological

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<sup>53</sup> The WTO treaty language is at times ambivalent and cloudy. Interpreting ambiguous language, now, is necessarily colored by one’s concept of the WTO. Lawrence (2003, p. 13) submits: “By convention, major WTO decisions require a consensus, and since members often have differing views and interests, it is not at all surprising that the rules are characterized by what is sometimes called constructive ambiguity. The result is that agreements are subject to very different interpretations that reveal more about the perspectives of the interpreters than about the meaning of the text. This is particularly the case when those approaching the WTO have strong normative preconceptions that color their view of what the system should be.”

interpretation (“contextualism”) must be brought to bear. Contextualism in essence means going back to the object and purpose of a legal norm and a legal regime in general.<sup>54</sup>

- Finally, textual interpretation methods seem to be of little help in light of the substantial discontent with the current DSU. WTO Member States, practitioners, and trade scholars alike (cf. footnote 2 above) have voiced their profound concerns about the WTO dispute settlement regime and WTO enforcement in general. Thus, interpreting presumably faulty language must be seen as a futile task from the outset. Going back to the roots and asking what the WTO is *conceptualized as* may seem much more fruitful an endeavor, and a necessary first step towards a workable institutional reform of the world trading system. Yet the compliance approach largely ignores this line of thinking.

There is a second shortcoming of the compliance perspective, the impact of which is amplified by its aforementioned dogmatic adherence to the interpretative technique of textualism: Compliance proponents must be criticized for clinically isolating the issue of dispute settlement from the logic of the entire Agreement. The compliance view puts a near-exclusive focus on treaty enforcement, and refrains from rooting enforcement into the wider systemic whole. Nowhere in the debate do compliance theorists attempt to explain whether or not there is a deeper systemic need in the WTO contract for trade policy flexibility beyond the tight confines accorded by the handful of trade contingency measures (see footnote 32 above). In the same vein, they do not justify the inherent logic behind their contention that a property rule is the only legal flexibility mechanism if unforeseen events occur. If a property rule of renegotiation truly was the only means of contract adjustment, advocates should be able to come up with a coherent explanation why WTO Members favored this rule of trade policy flexibility over other escape regimes. So far, any systemic justification for the compliance perspective of the WTO is wanting.<sup>55</sup>

These two shortcomings bear some important consequences, which equally cast doubt on the significance of the compliance approach as a convincing explanation of WTO enforcement:

**1. No distinction between the market access entitlement and other entitlements.** The compliance perspective of the WTO contends that there is a strict specific performance duty for all WTO Members. Unilateral “breach” for contractually unspecified reasons is impossible, least of all by using the DSB as an opt-out tool. It is thus consequent that property proponents frequently

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<sup>54</sup> Note that we use the term “contextualism” in a broader sense than usually applied by international lawyers. Generally, for L&E scholars (cf. e.g. Cohen 1999) contextualism means “searching for the deeper contractual intent” – an inherently theoretical and conceptual endeavor. Traditional lawyers, on the other hand, tend to look for the textual framework that a rule is embedded in. Confer Jackson’s definition of “contextualism” with respect to the compliance/rebalancing issue: “Analyzing the legal problem of obligation to comply therefore entails looking at the total framework of the DSU, to try to establish what the context is and the meaning of some of the specific clauses when viewed in that total context” (Jackson 2004, pp. 111). We have submitted *supra* that looking at the text of the DSU alone does not, however, resolve the more systemic issues at hand. For a discussion of textualism and contextualism in WTO treaty interpretation, see e.g. Petersmann (1998).

<sup>55</sup> Arguably, a coherent theory of the system is what legal methodologies lack in general, as Dunoff and Trachtman (1999, p. 3) seem to imply when uttering that “[i]nternational legal scholarship too often combines careful doctrinal description – here is what the law is – with unfounded prescription – here is what the law should be. This scholarship often lacks any persuasively articulated connection between description and prescription, undermining the prescription.”



speak about “treaty violation”, “enforcement”, and “punishment”, since *intra*-contractual non-performance is not an option (save for explicit contingency measures mentioned in the Agreements).

However, the compliance proponents’ firmness on a general performance obligation leaves a bulk of questions unanswered, including this one: “Performance of *what* obligation – and to *what end*?”. Unquestioning compliance with anything the WTO prescribes surely cannot be the purpose of enforcement. Contracts are concluded to achieve a specific objective, not for reasons of complying with just *anything*. There must be a deeper contractual logic as to the types of entitlements which signatories aim to exchange. But compliance advocates draw no systemic distinction between reciprocal market access entitlements and other legal entitlements traded in the various WTO Agreements. All entitlements seem to be lumped together and put under the specific-performance umbrella.

**2. *Quid in case of an intra-contractual liability fallback rule?*** Compliance proponents fail to explain how a (hypothetical) incorporation, or institutionalization, of an unconditional liability-type flexibility rule into the WTO treaty would bear on their compliance dogma. A contract-conform liability rule of escape would obviously have to form an integral part of the contract. This is certainly not what compliance advocates had in mind, when stating that compliance with the treaty is the central objective of WTO adjudication. However, apart from dogmatic adherence to a renegotiation rule, compliance advocates have little substantive argumentation to offer.

**3. No scope for trade policy flexibility instruments.** Proponents of the compliance view will be hard-pressed to explain why – conceptually – contractual escape is permissible under certain eventualities and conditions (e.g. GATT Arts. XIX, XX, XXI), but not under other – previously unspecified but potentially analogous – circumstances. The logic of contingencies in the mentioned articles exceeds the explanatory scope offered by compliance scholars.

**4. Compliance advocates accept the concept of flexibility by way of a “reasonable period of time”, yet deny flexibility via *non-compliance*.** For obvious domestic political reasons, the DSU grants the convicted injurers a reasonable period of time (RPT) to conform their policies, before countermeasures may set in. It would seem that by tolerating the RPT, WTO framers explicitly acknowledged that at least for some time a violation coupled with the withdrawal of concessions can be superior to immediate compliance. As Schwartz and Sykes (2002, p. 15) contend, there is no compelling systemic reason why the same (or similar) factors, which make immediate compliance impractical, should make defection for an *extended* period undesirable. Just like granting an RPT is apparently mutually beneficial (otherwise it wouldn’t have been included into the contract), the joint interests of parties may be better served by letting parties temporarily opt out of the contract in return for offering compensation or enduring retaliation. Compliance proponents are mute on this issue.

**5. Compliance proponents fail to explain the “toothlessness” of *de iure* sanctions.** As a matter of systemic logic of contracts, when two or more parties negotiate an accord, the outcome must be in the interest of all parties. If the outcome is not compatible with parties’ incentive structures, signatories would not accept the deal in the first place and prefer a breakdown of negotiations.<sup>56</sup>

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<sup>56</sup> If that weren’t the case, actors would either behave against their self-interest (and therewith cease to be rational), or be coerced into contracting. We want to assume away both alternatives.

So, if signatories agree on a property rule of entitlement protection, they do so because a strict obligation to perform is in their mutual interest.

Contract theory tells us that a property rule is best accompanied by coercively high punishments for defection. Everything else would render the regime of property rule protection difficult, since injurers would prefer violation over mandatory renegotiations. Prohibitive sanctions hence ensure that defection is successfully deterred and signatories behave according to the previously agreed rules of the game.

The compliance school does not offer a rationale for why the WTO framers did not go the extra mile to raise the bar for countermeasures above the *equivalence standard* of Art. 22.4 DSU. Enforcement of illegal behavior is rather “toothless” in the current DSU. Why did the framers of the WTO not choose stronger – incentive compatible – punishments when migrating from the GATT to the WTO regime of dispute settlement?<sup>57</sup> The answers for property-rule proponents may lie in the weak benchmark default rules of PIL, as stipulated in the Vienna Convention on the Law of Treaties (VCLT).<sup>58</sup> But then the question remains, why the founding fathers of the WTO didn’t “contract around” these default enforcement rules of PIL in order to install a more effective system of penal sanctions. Alternatively, it could be argued that some limitation in the magnitude of sanctions is essential even under a rule of specific performance in order to prevent “trade wars” from escalating.<sup>59</sup> However, this contention again fails to explain, why *equivalence*, and not, say, *appropriateness*, was chosen as the adequate ceiling on punishments. Also, why did the system of the GATT prior to the creation of the WTO hold together very successfully *despite* the absence of a meaningful constraint on the magnitude of sanctions?<sup>60</sup>

**5. Compliance proponents fail to explain the *liability fallback* of Art. XXVIII GATT.** Compliance advocates agree that the drafters of the WTO, cognizant of the complexity of the contract, acknowledged that both the rules of the game and the structure of concessions had to be modified from time to time. However, contrary to commentators from the rebalancing camp, they contend that all changes are to occur by way of mutual renegotiations – not by way of DSU

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<sup>57</sup> As mentioned above (footnote 27 and accompanying text), compliance proponents like to argue that the world trading system transformed itself from a pure rebalancing-oriented negotiation forum to a rule-of-law based organization, where compliance with the contracted rules is paramount. Note however that the punishment for violations has *not* changed from the “old” GATT to the “new” WTO system – it is still “equivalence” to the damage done (Pauwelyn 2000). “Remedies are there to ensure that contracts will under all circumstances be respected. Thus, remedies must be effective, and [...] this is not the case in the WTO context” (Mavroidis 2000, p. 811). Compliance advocates fail to explicate convincingly just why the relatively weak language of Arts. 3.7 and 22.4 DSU has been transposed *verbatim* from old GATT documents, yielding evidently ineffective outcomes from a property-rule perspective. On this note, Schwartz and Sykes (2002, p. 15) aptly state: “If WTO members really wanted to make compliance with dispute resolution findings mandatory, they would have imposed some greater penalty for noncompliance to induce it.”

<sup>58</sup> As Pauwelyn (2006, pp. 20) asserts, in public international law (self-)enforcement has traditionally been limited to a simple tit-for-tat (see also Grané 2001).

<sup>59</sup> By putting a cap on *extra-contractual* remedies, punitive overreach by WTO panels and the AB could be prevented, or an eruption of escalating trade wars – and therewith the risk of a system breakdown – avoided (Jackson 2004, p. 111).

<sup>60</sup> The positive consensus rule of dispute settlement under the old GATT 1947 allowed disputants to block the dispute resolution process from proceeding. The result of this positive consensus rule was that unilateral retaliation (such as resort to *Section 301* of the *US Trade Act of 1974*) could be applied at will. Nothing prevented nations from using inflated and punitive retaliation. Yet, trade wars rarely (if ever) emerged and multilateral liberalization made steady progress (see Sykes 2000, p. 352, WTO 2007, subsection II.D.3).

proceedings. For a modification of the tariff concessions in goods, compliance proponents point to the procedures of Art. XXVIII of the GATT as the proper rule of *ex post* flexibility (and the analogous Art. XXI GATS for services, Jackson 2004, p. 121).

Yet it must be stated that under this modification rule, market access concessions are ultimately protected by a liability fallback rule – not by a specific performance rule: Although the wording of Art. XXVIII GATT at first sight comes across a property rule of flexibility, the tariff renegotiation clause is effectively a *liability-rule* type opt-out accompanied by WTO arbitrators' interpretation of commensurate damages: Paragraph 3 of Art. XXVIII states that an injuring Member may proceed to *unilaterally* withdraw concessions in cases where negotiations over MFN compensation break down. Adversely affected trading partners may then bilaterally retaliate by withdrawing substantially equivalent concessions or other obligations through recourse to binding arbitration (as per Art. 22.6 DSU).<sup>61</sup>

This presents compliance scholarship with a non-trivial puzzle: The (alleged) compliance fallback of Art. XXVIII GATT is little else than a liability rule, and the damage amount payable to the victim is mandated to be “substantially equivalent” *both* under Art. XXVIII.3 and under the DSU proceedings of 22.4 DSU. Hence, just as rebalancing proponents suggest, it is hard to see any qualitative, systemic difference between using Art. XXVIII's opt-out opportunity and that of the DSU. Compliance advocates should have felt challenged by this contention and discussed this systemic puzzle. They did not. Compliance supporters should not keep on pointing to the WTO framers' unambiguous intentions in the DSU (and especially its Art. 22) without also explaining the (textually equally unambiguous) passages in Art. XXVIII GATT. The apparent conflict ought to be resumed by reverting to some sort of theory. Yet, property rule advocates so far have not given answer to this apparent inconsistency.

In summary, the compliance perspective is too dogmatic in its textual interpretation of the WTO, and too narrowly focused on issues of enforcement. It loses sight of salient systemic questions of contracting in connection with enforcement, such as Members' rationale for contracting, the nature of the initially traded concessions, the inherent logic of trade policy flexibility, and the systemic link between contractual flexibility and dispute settlement. The compliance view is generally too concerned with explaining what the DSU *is*, *says* and *does*, instead of looking at the bigger picture of the contract.

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<sup>61</sup> Pertinent parts of Art. XXVIII.3 read (emphasis added): “If *agreement* between the Members primarily concerned *cannot be reached* [...], the Member which proposes to modify or withdraw the concession shall, nevertheless, be *free to do so* and if such action is taken, any Member with which such concession was initially negotiated, any Member [...having] a principal supplying interest and any Member [...having] a substantial interest shall then be free not later than six months after such action is taken, to *withdraw* [...] *substantially equivalent concessions* initially negotiated with the applicant contracting party.” This paragraph essentially puts into effect a *liability*-type escape possibility for injurers. It effectively renders the previous renegotiation clause futile (see Schropp 2008, section 5.4.1, and Mahlstein and Schropp 2007).

## 4 A critique of the substance of the debate: Reframing the issue

The previous section showed that neither of the two approaches manages to give a flawless and comprehensive picture of object and purpose of WTO enforcement. Based on insights from contract theory, it will be argued in this section that the real problem of the compliance/rebalancing conflict is somewhat more fundamental: The compliance/rebalancing controversy was led in a reductionist manner, because it concentrated on the wrong subject. The debate should *not* have been seen as one about the current structure and design of WTO *enforcement*. Instead, it should have better been perceived as one dealing with the much more encompassing issue of contractual choice, i.e. the essence of the WTO contract in general. We believe that the compliance/rebalancing dispute constitutes a missed opportunity to address in a meaningful and scientific manner an engagement with the general nature of WTO treaty – the characteristics of the exchanged concessions (or entitlements) and how these entitlements are/should be protected against later instances of non-performance.

### 4.1 The essence of contracts

In a seminal contribution to the L&E discipline, Calabresi and Melamed (1972) laid down a very straightforward framework of “contracting”: Signatories to any contract are “making their own law” by exchanging residual ownership rights, also known as concessions, commitments or entitlements.<sup>62</sup> Contracting parties mold mutual commitments into a set of reciprocal rights and obligations that capture – as unambiguously as possible – nature, extent, and limits of the agreed-upon cooperation.

Signatories to any contract – whether it is the simple purchase of a candy bar or a complex, long-term, repeated-interaction treaty – generally perform three consecutive steps (cf. also Pauwelyn 2006, Trachtman 2006): First, by crafting the “primary rules” of contracting, signatories define and assign the initial entitlements in form of mutual rights and obligations.<sup>63</sup> Primary rules are the essence of the contract, since they establish the level of cooperative ambition.<sup>64</sup> In a second stage, signatories agree on rules of entitlement protection. These “secondary rules” of contracting allocate *residual decision rights* between signatories. Residual decision rights lay down how, and how rigidly, an initial concession is to be protected from *ex post* discretion, or flexibility, over the course of the contractual relationship. After having delineated *intra*-contractual, permissible, non-performance behavior, transactors in a third step accord how to sanction *extra*-contractual, uncooperative, behavior. These “tertiary rules” comprise of enforcement mechanisms and dispute

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<sup>62</sup> Residual ownership- or property rights are the “individual’s ability to directly consume the services of an asset, or to consume it indirectly through exchange” (Barzel 1997 at p. 3).

<sup>63</sup> The primary rules of contracting comprise of “substantive” and “contracting” entitlements (see Schwartz 1992, p. 284): Every contract entered into voluntarily is concluded for the purpose of increasing the welfare of all signatory parties. *Substantive entitlements* lay down the contractual intent and circumscribe the envisioned gains from cooperation. *Contracting entitlements* specify the parties’ desire to achieve substantive goals in the best way possible. Contracting clauses give the contract additional structure over and above a mere specification of its envisioned objectives. Although they only have an indirect, secondary effect, they are important for closing loopholes and forestalling *ex post* opportunism.

<sup>64</sup> Primary rules of entitlement circumscribe the “depth” and “breadth” of a contract and therewith lay down the gains from trade to be had from cooperation. The *breadth* of a contract is characterized by the number of cooperative goals (or “issue areas”), while *depth* represents the level of cooperative zeal within each issue area (e.g. size of tariff cuts in the sector “hot-rolled special steel”).

settlement procedures taken in response to the illegitimate taking or destruction of a contractual entitlement.

Secondary rules of entitlement protection allow the contracting parties to react to unexpected – hence previously unspecified – contingencies or shocks: Whenever an unforeseen event occurs during the performance of a contract, such contingency may cause “regret” in one or more signatories of the contract.<sup>65</sup> Secondary rules define the legal limits of escape, and therewith help deflate regret, since they lay out the scope for trade policy flexibility.<sup>66</sup> Intuitively, the more incomplete a contract, the more important is the careful design of secondary rules.<sup>67</sup>

Three generic types of *ex post* escape are usually described in the literature: (i) inalienability-, (ii) liability-, and (iii) property rules of entitlement protection.

- (i) Whenever an *ex post* entitlement transfer (to take, sell, or trade residual rights) is considered inefficient or immoral, a rule of *inalienability* (henceforth IR) is agreed upon by signatories (e.g. Jolls 1997). An IR mandates unconditional specific performance of the contractual rules, no matter what contingencies may occur in the course of contract performance.
- (ii) If contracting parties generally consent to the possibility of trading or reallocating entitlements *ex post*, they must determine whether to protect initial entitlements by means of a *liability rule* (LR) or a *property rule* (PR) of entitlement protection. As explained above, under a pure LR, one party (the taker or injurer) has the option to *unilaterally* seize parts of the other party’s entitlement – without the latter’s prior assent. The taker hence may engage in the unilateral appropriation (which effectively is an expropriation of the holder of the entitlement), under the condition that he compensates the owner (or victim) for damages suffered – usually by paying a *previously specified* exercise price (the damage remedy).
- (iii) Under a PR of entitlement protection, both parties are under a strict obligation to respect the initial entitlement distribution, and a failure to do so will be punished severely. However, a party experiencing regret can buy off the owner’s entitlement through *renegotiations* (see footnote 30 above): The injurer (rather: the requesting party) can avoid his commitments by

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<sup>65</sup> A word on the concept of contractual “regret”: A signatory experiences regret whenever an *ex ante* envisioned transaction value is not realized in light of newly revealed information. An unanticipated contingency arises which – had it been known *ex ante* – would have changed the initial content of the contract. Termed differently, regret occurs in instances where a perfectly contingent contract (cf. footnote 44 above) would have excused performance, but the provisions of the real (incertitude-ridden, incomplete) contract erroneously mandated it. Regret is a function of the magnitude of the unexpected shock (the “regret contingency”), and of the depth and breadth of *ex ante* commitments.

<sup>66</sup> Conceptually, the issue of *ex post* flexibility is the flipside of the level of legal entitlement protection (cf. Dunoff and Trachtman 1999, p. 32): The level of *entitlement protection* determines the *ex post* action space of contracting parties. It sets out whether and how parties are allowed to react to changing circumstances that occur in the course of contractual performance. Analogously, parties’ choice of *policy flexibility* mechanisms lays down what behavior is permissible in case of a contractual gap, caused by an unforeseen/unspecified contingency. So, while flexibility provisions nail down the legitimate (*intra-contractual*) behavior of the *active* party, entitlement protection is concerned with the well-being of the *passive* party.

<sup>67</sup> If – hypothetically – a contract were complete in that it specified in detail *all* possible contingencies and prescribed comprehensive plans of actions, flexibility mechanisms would be superfluous. Every *ex post* non-performance then would by definition be *extra-contractual*, i.e. constitute punishable behavior. See Shavell 1980, p. 467: “[A] Pareto efficient complete contingent contract is one to which the parties would find it in their mutual interest to be *bound* to adhere. In particular, they would wish for damages for failure to meet the terms of the contract to be set sufficiently high that the terms would always be obeyed” (emphasis in original).

securing permission from the victim (rather: the concerned party) – usually by paying a *negotiated* amount. Whenever the parties come to an agreement, the victim cedes her entitlement and sells it to the requesting party – the transfer is thus *bilateral*.

Any rule of *intra*-contractual non-performance must be accompanied by a corresponding remedy:<sup>68</sup> At the conclusion of the contract, signatories agree on how “costly” legal escape by the injurer should be. The economic function of *intra*-contractual remedies clearly is to alter the incentives of the regret party and to grant the victim(s) indemnity for the injurer’s (partial) default. There is a continuum of remedies ranging from zero- to coercive (infinitely high) damages.<sup>69</sup>

Primary and secondary rules of contracting need to be defended against abusive injurer behavior by means of a protective belt of enforcement rules (*extra*-contractual remedies): Signatories need to be incentivized to only utilize the legal escape tools (and pay compensation for doing so), and deterred from engaging in defective behavior. Note that not all combinations of escape and remedy rules make equal sense: Inalienability rules are best adhered to by coercive penalties (prison, forfeit, coercive liquidated damages, etc.). A property rule is accompanied by bilaterally negotiated remedies, and protected by coercive penalties. Liability-rule protection can be accompanied by various forms of *intra*-contractual remedies (see preceding footnote), but must equally be defended against *extra*-contractual violation of the rules by means of effective enforcement remedies *in extenso* of *intra*-contractual remedies (otherwise injurers would always prefer breach to using legitimate escape tools).

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<sup>68</sup> Following standard contract-theoretical terminology, the term *remedy* is used here in a comprehensive sense, so as to cover *any* action aimed at undoing unanticipated behavior by one contracting party. It is the generic term encompassing *intra*-contractual remedies (compensation, indemnity) and *extra*-contractual enforcement (sanctions, punishment). Our understanding of *remedy* is notably different from the customary *extra*-contractual connotation it bears in the WTO literature – or, for that matter, in PIL in general, as spelled out in the ILC Draft on State Responsibility (see Mavroidis 2000, Grané 2001, Vazquez and Jackson 2002): In the WTO context, *remedy* is either used in a broad sense as covering any solution between (two or more) WTO Members *once a matter has been formally raised*, i.e. consultations have been officially requested under Art. 4 DSU. This broad notion comprehends the type of legal claim by the complaining party (violation, non-violation-, or situation complaint), as well as all ensuing procedural alternatives, including withdrawal of the measure, enactment of alternative measures in compliance with the rules, bilateral settlement, retaliation, and tariff compensation offers (Mavroidis 2005). Usually, however, WTO scholarship employs the notation *remedy* in a narrow sense as a legally sanctioned response pursuant to *noncompliance* by a defendant whose practices have been multilaterally condemned. DSU remedies, narrowly defined, are comprised of the WTO-legal countermeasures, namely retaliation and tariff compensation (Mavroidis 2000, p. 800).

<sup>69</sup> The most common damage remedies are (e.g. Mahoney 1999, pp.121):

- The *restitution* remedy, which re-establishes the *status quo ante* the *contract*. An injurer must restore the Nash-level that persisted before the contract in the non-cooperative past. In other words, restitution damages reconstruct what the contract would look like if the measure in question had never been part of the initial deal.
- The *reliance* remedy obliges the injurer to re-establish the victim’s *status-quo ante* the *breach*. It aims at reestablishing a world that would exist if the illegality were removed. One conceivable way of “paying” reliance damages is to seize a contested measure and return to fully cooperative behavior.
- The *expectation* remedy places the victim in as good a position as it would have been had the injurer performed his contractual obligations. It is equivalent to the *replacement value* that exactly makes the victim indifferent between the injurer’s performance and his default. Expectation damages are essentially what is called “commensurate damages” in game theory: They insure the victim against any dynamics that unfold *ex post*.

## 4.2 No discussion of enforcement without comprehension of the contract

With this definitional groundwork on rule-making we can now bring forth the central hypothesis of this paper: We believe that the compliance/rebalancing debate's exclusive focus on enforcement is neither justified nor pertinent.

As a matter of scientific rigor, and as a requisite of logic a discussion of enforcement must be seen as vacuous *without* a prior occupation with the nature of the contract. In the absence of a good grasp of the underlying accord, and without a proper deliberation of what constitutes legal behavior in the first place, any examination of rules of enforcement is bound to remain patchwork.

It is slightly puzzling that the framers of the compliance/rebalancing controversy did not heed this simple insight. Instead, scholars on both sides of the debate put the cart before the horse by theorizing narrowly over *extra*-contractual entitlement protection ("tertiary rules" of contracting), thereby neglecting that the nature of law contracted is the prime input to discuss, before the issue of protection against genuine contractual misdemeanor can be evaluated in a meaningful way. In brief, commentators on both sides of the divide argued about how to deal with defection from the WTO treaty *without* having defined before *what kind of behavior constitutes a defection* in the first place.<sup>70</sup>

The nature of law contracted and contract-intrinsic aspects of trade policy flexibility must logically be examined before protection against contractual defection can be evaluated. Hence, the compliance/rebalancing debate ideally would have consisted of the following suite of questions:

1. Why did countries conclude a trade agreement in the first place, and what are the initial rights and obligations exchanged by the contracting parties? (read: What are the primary rules of contracting?);
2. How are entitlements (best) protected, and what constitutes legal non-performance? How can/should parties engage in *ex post* trade policy flexibility without violating the rules of the game? (read: What are/should be the secondary rules of contracting?);
3. How are entitlements (best) protected from *extra*-contractual, illegal behavior? What rules of dispute settlement and enforcement are/should be in place to protect signatories' rights against defection? (read: What are/should be the tertiary rules of contracting?).

The framers of the compliance/rebalancing debate have not argued on the basis of above research questions. Instead, they got entangled in the downstream issue of enforcement (question 3). The controversy was thus built on the wrong fundament. This is consequential, since asking the wrong questions rarely leads to the right answers.

## 4.3 Reframing the debate in light of the *nature* of the contract

If we reinterpret the compliance/rebalancing controversy in light of the above suite of research questions on the nature of the WTO contract, we come to an interesting realization: WTO scholars on both sides of the debate *did* broach the broader issues of original entitlements, trade policy flexibility and remedies – albeit in an *implicit*, unarticulated manner. Our characterization of the two schools of thought in section 2, and especially our critique in section 3, suggests that the compliance/rebalancing debate at its core is not primarily a controversy about defection and

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<sup>70</sup> To this day WTO scholarship has engaged in a dispute akin to whether the referee had made wrong decisions – without having reconciled *just which ballgame* is the subject of discussion.

sanctions, or about the legal bindingness of panel rulings. Rather, the real cornerstone of contention in the controversy is effectively the fundamental issue of *contractual choice* (or *rule-making*): What kind of beast is the WTO contract? Both the compliance and the rebalancing approach provide entirely different interpretations of the nature of the WTO contract, and of the permissibility and desirability of partial withdrawal from previously made contractual obligations. To illustrate, consider Chart 1:

**Chart 1: Rephrasing the compliance/rebalancing debate in WTO scholarship**

School of thought Contracting stage	Rebalancing approach	Compliance approach
I Initially exchanged entitlements	Market access commitments	n.p.
II <i>Intra</i> -contractual entitlement protection	Liability rule	Property rule
III Enforcement: <i>extra</i> -contractual entitlement protection	n.p.	Coercive punishments

Source: author

Notes: This Chart is a reinterpretation of the compliance/rebalancing debate in light of the nature of the WTO contract. Instead of seeing the discussion merely as one about contractual enforcement (or tertiary rules of contracting, III, shaded bottom row), the controversy must be reframed within the basic three steps of contracting: The two perspectives are compared according to their perception of the nature of contractual entitlements (or primary rules, I), the rules of *intra*-contractual entitlement protection (secondary rules, II), and of enforcement. *n.p.* stands for “not pertinent”.

Chart 1 revisits the compliance/rebalancing controversy in light of and with regard to the three stages of contract design. Primary, secondary and tertiary rules of contracting are plotted on the vertical axis. Reframing the two schools of thought in that manner reveals the actual extent of the debate between the two rivaling schools of thought:

- The *rebalancing* approach reduces the WTO to a single-entitlement contract, in which uniquely reciprocal market access concessions, or tariff liberalization commitments are traded. These mutual liberalization commitments are *de facto* protected by a pure LR of entitlement protection. Every signatory can opt out of the Agreement under any circumstance, given the injuring country pays its compensation or at least does not obstruct retaliatory self-help measures on the part of the victim Member. The rebalancing approach is largely agnostic over *extra*-contractual rules of enforcement, simply because under a pure LR an injuring country is contractually allowed to withdraw any concession at any point of time; this somehow renders considerations of illegal behavior futile.



- The *compliance* approach takes the WTO as a multi-entitlement contract. However, compliance advocates do not explicitly make the logical distinction between different entitlements. *Every* contractual right and obligation is protected by a PR of default; any state of nature that is not explicitly listed in the text as an exception or contingency measure must be addressed through renegotiations. Everything else amounts to a violation of public international law. This PR of flexibility is protected by the rigid language of the DSU, whose explicit task it is to coerce the violator into compliance with the rules of the game and the rulings of dispute panels.

In summary: The present compliance/rebalancing controversy is misguided, because it started – and got stuck – in the subsequent issue of dispute settlement and enforcement. The debate built a house with an elaborate second floor, but neither fundament nor ground floor. As a consequence of having placed a subordinate question at center stage the debate took a wrong spin, and the two schools of thought spiraled out along two different – non-matching – trajectories. Rebalancing and compliance scholars actually describe two different contracts: While the rebalancing approach depicts a pure market access contract, and reflects upon *intra*-contractual safety valve mechanisms, compliance theorists portray the WTO as a full-blown, multi-purpose, multi-entitlement treaty, and contemplate the international legal bindingness of panel rulings and the enforcement of WTO rule violations in general. This explains the origin of the alleged *discours des sourds* between the two rivaling camps.

#### **4.4 A digression: The compliance/rebalancing debate has overlooked a third approach to the WTO**

As a corollary to our proposition that the subject matter of the compliance/rebalancing controversy is myopic and misguided, it seems that the framers of the debate overlooked the existence of a third and competing perspective on the nature of the WTO. Next to the compliance approach (which implicitly propagates a general PR of default), and the rebalancing view (which alleges a LR system of default), and indeed on par with the other, we can extract an *inalienability* perspective on the nature of WTO obligations from the literature. This view on the WTO mandates a general rule of inalienability and prohibits any *ex post* discretion.

**Chart 2: Extending the compliance/rebalancing debate**

School of thought Contracting stage	Rebalancing approach	Compliance approach	Inalienability approach
I Initially exchanged entitlements	Market access commitments	n.p.	Trade liberalization commitments
II <i>Intra</i> -contractual entitlement protection	Liability rule	Property rule	Inalienability rule
III Enforcement: <i>extra</i> -contractual entitlement protection	n.p.	Coercive punishments	Coercive punishments

Source: author

Notes: This is an extended version of Chart 1 above. It shows that WTO scholarship has brought forth at least one more conception of the nature of the WTO, namely the inalienability approach (grey column).

As Chart 2 illustrates, the inalienability perspective on the WTO has a very different, and indeed rivaling, notion of the nature of the contract: It views the WTO treaty as a global trade constitution which is protected by an unconditional rule of immutability. For proponents of the inalienability school of thought, the WTO is a direct extension of national constitutions and aims at protecting basic economic property rights against post-contractual protectionist backtracking or any kind of governmental opportunism.<sup>71</sup> According to WTO constitutionalists, countries, or rather peoples, cognizant of the positive effect of freer trade, engage in trade liberalization. Protectionist acts by selfish governments at home and abroad threaten this achievement; they constitute a form of unlawful expropriation.<sup>72</sup> WTO rules are deliberately conceptualized by Member States in a rigid manner, so as to tie the hands of current and future trade policymakers, who may otherwise be tempted to fall prey to domestic protectionist pressures.

Inalienability proponents draw on theoretical support from two sources. The first one they rely on is the economic “commitment approach” to trade agreements.<sup>73</sup> This approach argues that (self-

<sup>71</sup> Contributions to WTO scholarship in the constitutionalist vein include Regan (2006); Gerhart (2003), McGinnis and Movsesian (2000); Petersmann (1986, 2002, 2003), and Tumlrir (1985). Hauser and Roitinger (2004, pp. 642) and WTO (2007, section II.D) provide explanation and overview of various constitutional approaches to the WTO.

<sup>72</sup> Protectionist measures by domestic policymakers not only give rise to economically inefficient production decisions, and therewith take domestic consumers and consuming industries at a disadvantage. Moreover, retaliatory actions by victim countries may be targeted at uninvolved domestic sectors which have not been at fault in any way. A retaliatory denial of market access then deprives the targeted industries of their economic right to do business as previously consented to – it may reach a form of expropriation. In addition, WTO rules on retaliation amount to “collective liability”, in which uninvolved parties get punished for acts not committed by them. Collective liability is a controversial legal concept (see Charnovitz 2001 at note 159, Petersmann 2002; 2003, Bronckers and van den Broek 2005).

<sup>73</sup> In the field of international economics, the commitment school is an alternative explanation to the externality-driven rationale for trade agreements (cf. main text around footnotes 10-12). It alleges a

interested) policymakers utilize *external* pressure generated by the binding conclusion of an international contract to overcome a domestic “time-inconsistency” inefficiency resulting from the strategic interaction between government and the private sector.<sup>74</sup> A second source of theoretical support stems from international legal scholars. For them, inalienability is not just an economic imperative, but a logical consequence of the most widely acknowledged *ius cogens* norm of *pacta sunt servanda*. A rule of inalienability then is just the codification of this legal dogma.<sup>75</sup>

The inalienability view of the WTO sees the treaty as a “renegotiation-proof” (Holmström and Tirole 1989, p. 68) contract that cannot be revised, enhanced, modified, or complemented in any manner except in ways originally laid down in the text. Constitutional rigidity upholds the predictability and stability of the system, and it advantages non-state actors who are normally under-represented in the domestic trade policymaking process (consumers, enterprises, civil society groups). The issue of whether the WTO treaty is a complete or an incomplete contract notwithstanding, proponents of the inalienability school argue that any gain connected to the exercise of trade policy flexibility is easily outweighed by general (immediate, long-term, or systemic) welfare losses entailed in a system of flexible *ex post* non-performance. Just as you cannot step back from or infringe on constitutional obligations in unspecified circumstances, so the argument goes, it is equally pernicious to change the content of the WTO agreements in any way.<sup>76</sup>

Enforcement under the inalienability perspective is vital, even more so than under a property-rule protection. Any defection from the letter of the law must be punished – with verve, if necessary. Inalienability theorists, accordingly, have not shied away from demanding high penalties for misdemeanor in the WTO-context (Petersmann 1986, McGinnis and Movsesian 2000, Regan 2006).

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distinct inward-oriented domestic problem that can be solved by international trade accords. A trade agreement is concluded to deliberately restrict future discretion of governments over trade policy. In the face of protectionist pressure by domestic interest groups and in the presence of “time-inconsistency” (which prevents governments from credibly committing to a future change in policy), policymakers deliberately “tie their hands to the mast of free trade” (Regan 2006) in order to maximize their *long-term* self-interest. By exposing themselves to the risk of sanctions in case of protectionist backtracking from previously made trade liberalization concessions, domestic trade policymakers can credibly commit to welfare-superior commitments (*lock-in effect*). Unconditional commitment to an international agreement is thus used as a signal vis-à-vis domestic actors that the government cannot afford to renege on its initial contractual commitment, and that *ex post* backtracking is not an option. This external threat makes the policy announcement *ex ante* credible vis-à-vis domestic agents. The commitment approach to trade agreements is in its infancy (Bagwell and Staiger 2002 at p. 35) and so far has largely failed to bring forth credible evidence (Mavroidis 2007, chapter 1, Srinivasan 2006). Some commentators have voiced theoretical concerns with the commitment approach (see Schropp 2008, section 4.1.2.4 or WTO 2007, section II.B for an overview).

<sup>74</sup> Proponents of this view in the field of international economics are Staiger and Tabellini (1987, 1989, 1999), Krishna and Mitra (1999), Maggi and Rodriguez-Clare (1998) and Mitra (1999). Maggi and Rodriguez-Clare (2005) and Bagwell and Staiger (2005b) combine market access- and internal commitment explanations for the existence of trade agreements.

<sup>75</sup> Dunoff and Trachtman note (1999, p. 32): “Some international lawyers will reject the concept of efficient breach on a normative basis. They might argue that accepting the efficient breach hypothesis would threaten precisely the feature that renders treaties the ‘major instrument of international cooperation in international relations’ – the belief that treaties will be obeyed, even when contrary to the state’s immediate, short-term interest. Encouraging, through law, ‘efficient’ breaches of these treaties would undermine the fundamental rule of *pacta sunt servanda*, and likely render more difficult the possibility of sustained cooperation in an international community through treaty regimes” (cf. also Pauwelyn 2006).

<sup>76</sup> Also, since in some countries WTO jurisdiction has a *direct effect* (or “self-executing” effect) on domestic legislation, renegeing on WTO rules would be tantamount to infringing domestic legislation – a precedent with unfathomable consequences (cf. Jackson 1997b, pp. 61).

## 5 Conclusion: Towards a unified research agenda

This paper devoted itself to well-known *and* overlooked issues of the decade-old compliance/rebalancing debate. On a positive note, the controversy between compliance advocates and “rebalancers” can be seen as an important step towards structuring the eclectic and incoherent literature concerning reforms of DSB processes and WTO enforcement instruments. It is important and indeed logical that any fruitful discussion of DSB reform must be preceded by one about the object and purpose of dispute settlement and enforcement (see discussion in footnote 3 and accompanying text)

On a negative note, we are witnessing a *discours des sourds* between the two rivaling camps. It seems that the two schools have lost touch with each other: In arguing about the objectives of rule enforcement, the framers of the debate ostensibly stopped short of addressing much more salient issues of contracting. They missed a unique opportunity to engage in the superordinate discussion of initial entitlements exchanged in the WTO, its system of trade policy flexibility, and the design of its *intra-* and *extra-*contractual remedies. What’s more, commentators on both sides seem to have been ignorant of the fact that they were talking cross-purposes all along, and that rebalancing and compliance scholars essentially describe two vastly different contracts: *Rebalancing* proponents portray the WTO as a pure market access exchange contract, and theorize about *intra-*contractual safety valve mechanisms, which they assume to be of the liability-rule type. *Compliance* proponents characterize the WTO as a full-blown multi-entitlement treaty, and are primarily concerned with the international legal bindingness of panel rulings and the enforcement of WTO violations in general. Systemic issues of trade policy flexibility in a dynamic world do not feature prominently in their considerations.

Had there been a full-fledged discussion about the nature of contractual obligations and their protection from the start, the ringleaders of the compliance/rebalancing debate would probably have realized that there are at least three – not two – rivaling mindsets in WTO scholarship. The inalienability approach, which propagates unconditional specific performance and a prohibition of *ex post* trade policy flexibility, is indeed an additional genuine perspective on the WTO Agreement.

It is time to leave behind the antinomy and to end the compliance/rebalancing saga. We believe that there is effectively much less tension between the competing views than even the framers of this debate suspected. Building on the fundamental insight that a theory of the nature of a contract must necessarily precede any discussion about enforcement, we want to sketch an integrative framework for analyzing the WTO contract. We draw lessons from the previous analysis (subsection 5.1) and present a proposal for a unified research agenda (subsection 5.2).

### 5.1 Lessons learned from the debate

#### ***Lesson 1: The importance of primary rules of contracting – The WTO is a multi-entitlement contract***

It seems evident that the WTO is by no means a single-entitlement contract, where parties solely exchange one contractual obligation, be it the entitlement to market access or any other promise. Instead, the WTO Agreement is a multi-entitlement accord, at least consisting of (i) the prominent reciprocal market access entitlement, (ii) various minimum-standard entitlements, and (iii) auxiliary entitlements.

- (i) **The reciprocal market access entitlement.** It is a WTO Member's right to compete fairly in the market of its trade partner(s) up to the degree granted by each of its partners. The market access entitlement forms the backbone of the GATT and the GATS. It is composed of *substantive* and *contracting* obligations (see footnote 63 above). The *substantive* obligations define the reciprocal trade liberalization commitments in form of tariff cuts and service concessions in the four GATS service modes of supply.<sup>77</sup> Yet the market access entitlement consists of more than just substantive commitments to trade liberalization. Integrated into the market access entitlement are *contracting* provisions aimed at maintaining and stabilizing the initially agreed-upon level of bilateral cooperation.<sup>78</sup>
- (ii) **Minimum-standard entitlements.** The bilaterally owed trade entitlement is crucial, albeit not the only entitlement exchanged in the WTO contract. As Pauwelyn (2006 at footnotes 91 and 93) aptly states, there are other non-market access-related entitlements in the WTO which are inexplicable by the logic of reciprocal tariff concessions. The so-called new issue areas of the WTO, as laid down in the TRIMs and TRIPS, the ILP,<sup>79</sup> and other plurilateral WTO Agreements, may be seen as accords based on a motivation quite distinct from the reciprocal exchange of market access.<sup>80</sup> The objective of these minimum-standard provisions is to reap positive concessions from every participating Member (e.g. de Bièvre 2004). Multilateral entitlements oblige every signatory to adhere to an agreed core set of legal standards and to abide by the same "rules of the game". A series of positive integration rules mandate the introduction of certain institutional features and procedures – independently of the state of implementation in other countries.<sup>81</sup>

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<sup>77</sup> Substantive trade liberalization concessions form the core of any trade contract. The level of market access is equivalent to the size of the promise – the number of sectors and the degree of market-opening signatories agree to be bound to. It lies in the contractual nature of the WTO that the trade entitlement is *reciprocally owed*. Each contracting party enters into a bilateral trade liberalization deal with every other WTO Member, and fixes its level of market access depending on the access to foreign markets it is granted in return. For mercantilist or welfare-economic reasons, it is in the interest of every trade negotiator to extract the most extensive trade concessions possible from other contracting parties and to "give away" as few concessions as possible (Bagwell and Staiger 1999, Bagwell, Mavroidis and Staiger 2002, Bagwell and Staiger 2002). Whether or not an accord between parties *A* and *B* frustrates previous market access commitments of another third party *C* is *a priori* irrelevant to the governments of Members *A* and *B*, as long as doing so does not affect their respective utilities. The market access obligation is consequently organized in a web of bilateral deals. Despite the most-favored nations obligation of Arts. I GATT and II GATS (rules geared towards reducing transaction costs and negative spillovers), the right to trade is not owed to the collective membership, but *directly* to every signatory.

<sup>78</sup> Examples for *contracting* provisions are non-discrimination stipulations (e.g. Art. I and III GATT); a prohibition of quantitative restrictions (e.g. Art. XI GATT); codes of conduct detailing how to deal with non-tariff barriers (e.g. Art. III GATT, or the SCM, TBT and ROO Agreements). Explicit exceptions to the right to compete in foreign markets also form part of the trade entitlement (such as Arts. IV, XVII, XXIV GATT, or the "Enabling Clause"), as do waivers (e.g. Art. IX of the Marrakech Agreement).

<sup>79</sup> The acronyms stand for "Agreement on Trade-Related Investment Measures", "Agreement on Trade-Related Intellectual Property Rights", and "Agreement on Import Licensing Procedures", respectively.

<sup>80</sup> Other "new WTO issues", such as competition, investment, trade facilitation, labor and environment, belong to the same category of positive integration rules. These new issues have not yet been cast into WTO Agreements, but have been on the bargaining table for some time (for in-depth introduction into new trade policy issues, see Hoekman and Kostecki 1995, Jackson 1997a, pp. 305-18, Trebilcock and Howse 2006).

<sup>81</sup> Positive integration norms are based on a "thou shalt..." (prescriptive) logic, whereas negative integration norms are based on a "thou shalt not..." (prohibitive) logic. Positive norms mandate the establishment of a certain result or effect, while negative norms prohibit certain behavior or outcomes.

What sets minimum-standard entitlements apart from the bilaterally owed market access entitlement is that the former are owed to the contracting community as a whole, i.e. they clearly have a multilateral ambit. Their *erga omnes partes* logic is distinct from a bilateral logic.<sup>82</sup> For reciprocal entitlements the *rights* of one contracting party constitute the *obligations* of the other. A multilateral entitlement, on the other hand, is not exchanged on a *quid pro quo* basis; it is *owned by* the entire membership, as well as *owed to* the WTO community as a whole. If a country violates its multilateral entitlement to, say, supply patent protection and establish a functioning patent office under TRIPS, this Member impairs the competitive opportunities of all other Members. It brings down the general level of operations and harms the system as a whole.

**(iii) Auxiliary entitlements.** The WTO also comprises a vast number of auxiliary entitlements – social ordering devices that supply the trade agreement with a fundamental structure necessary to facilitate the underlying exchange that the substantive entitlements circumscribe. Auxiliary entitlements are also phrased as positive *erga omnes partes* norms and rarely leave any degrees of freedom to transactors; they oblige all contracting parties to the same degree.

We propose to distinguish four types of basic auxiliary entitlements in the WTO: (i) procedural rules,<sup>83</sup> (ii) transparency entitlements,<sup>84</sup> (iii) obligations owed to the Institution,<sup>85</sup> and (iv) “external” entitlements.<sup>86</sup>

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<sup>82</sup> See the discussion in footnote 29. Multilateral obligations are sometimes called *obligations erga omnes partes* (cf. Pauwelyn 2001), since they are owed to the entire membership. This nomenclature, however, may be perceived as misleading, because *as a matter of positive law* (by virtue of Art. 3.4 DSU), WTO rights and obligations are *de iure* applicable to *all* WTO Members. Based on this insight, some scholars have argued that reciprocity and bilateral market access-related rights and obligations are a thing of the past, and that all contemporary WTO-legal obligations have a multilateral ambit (e.g. Pauwelyn 2000, Charnovitz 2001; 2002a, Jackson 2004). We beg to differ: As we explained in footnote 77 above, the *logic* of the market access entitlement is inherently bilateral, even though it is *de iure* owed to the all WTO Members. We will hence use the terminology *erga omnes partes* only for those entitlements that logically have a multilateral ambit.

<sup>83</sup> The WTO knows a whole range of procedural rules that delineate organizational issues, such as time-lines (e.g. those laid down in Arts. 4, 8, 16, 17, 20 and 22 of the DSU), rules of decision-making (Art. IX of the Marrakech Agreement), voting and selection procedures (e.g. Art. 8.4 DSU on dispute panel composition), disclosure requirements (such as those in Art. XXIV.7 GATT, or Arts. 3, 4, 10 or 25 of the DSU), or general provisions of *modus operandi* (such as Arts. XXII, XIV and XV of the Marrakech Agreement on *accession, acceptance, entry into force and deposit, and withdrawal*, respectively).

<sup>84</sup> Transparency obligations are scattered across WTO Agreements. Their objective is to reduce unnecessary search and error costs in connection with economic exchange. We find Wolfe’s (2003) classification helpful. He groups transparency provisions into: (a) tariff and services schedules which codify Members’ commitments; (b) the Trade Policy Review Mechanism; (c) publication and notification; (d) internal transparency which ascertains transparency of the institution to its Members; and (e) external transparency to civil society (see also WTO 2007, chapter II.3.5chapter II.C.5).

<sup>85</sup> Examples for obligations owed to the Institution are yearly financial contributions by Members to the WTO or the obligation to assign trade experts to serve on dispute panels.

<sup>86</sup> External entitlements delineate contractual freedom in the WTO. International trade has crucial ties to many other activities of international concern (Pauwelyn 2003). Hence, PIL is the relevant “playground”, or domain in which WTO Members are free to contract (cf. footnote 28 and accompanying text). Of special importance are peremptory norms of international law (*ius cogens*), which have acceptance among the international community of states as a whole, not for WTO Members only. Unlike norms of customary international law which can be modified by mutual consent or subsequent practice, WTO Members must not “contract around” *ius cogens* norms. Any treaty in violation of a peremptory norm is null and void (Art. 53 VCLT; cf. Malanczuk 1997, p. 375).

The reader may prefer a different classification of WTO entitlements. Yet one thing seems certain: The WTO is a *multi-entitlement* treaty, and singling out one entitlement and its protection leads to interpretative flaws and misunderstandings. Without giving reasons and without acknowledging the presence of other entitlements, the rebalancing view on the WTO largely restricts itself to the study of the reciprocal market access entitlement. Consequently, it infers faulty conclusions about the objective of WTO enforcement, let alone of the general nature of the WTO treaty. Compliance activists are somewhat more nuanced in their take on the entitlements traded in the WTO (see footnote 46 above), but nowhere do they attempt to categorize and characterize the different primary rules of contracting (the notable exception being Pauwelyn 2006).

### ***Lesson 2: The secondary rules of contracting – The importance of trade policy flexibility tools***

Our analysis showed that the rebalancing approach – in contrast to the compliance school of thought – are aware of the need for *intra-contractual* trade policy flexibility mechanisms in a non-stationary world. Rebalancers argue that *violation-cum-retaliation* can be used as a *de facto* safety-valve in situations where previously unforeseen contingencies occur and the current letter of the treaty is insufficient in successfully addressing them.<sup>87</sup>

Rebalancing scholars correctly recognize the intricate systemic connection between trade policy flexibility, enforcement, and cooperative zeal.<sup>88</sup> However, there are two shortcomings in their argumentation:

- First, the rebalancing approach does not pay sufficient regard to qualitative distinctions between the protection of the bilateral market access entitlement on the one hand, and non-reciprocated, multilateral entitlements on the other. Indeed, multilateral *erga omnes partes* obligations may best be protected by different flexibility regimes than a LR of opt-out. This is typically the case when the damage is not easily “monetizable”, or when *ex post* discretion is prone to crowd out cooperative behavior *ex ante* (see the discussion in footnotes 47/48 and accompanying text; cf. also Schropp 2008, section 7.3).
- Second, rebalancing proponents fail to address the qualitative distinction between *intra-contractual* non-performance (trade policy flexibility) on the one hand, and *extra-contractual*

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<sup>87</sup> The *EC – Hormones* cases (WT/DS 26 and 48; 320 and 321) have demonstrated that the European Communities, for political, social or health reasons, wished to withdraw from a previously made market access commitment. This endeavor was not backed by any formal WTO escape clause: Given GATT Art. XIX’s narrow application scope (permitting escape only in reaction to *economic* shocks), and heeding the arguable inadequacy of Art. XXVIII renegotiations as a safety valve, the EC felt obliged to keep on violating the GATT Agreement. (This is, of course, only one way of interpretation. Other observers may argue that the EC acted malevolently, or was “putting to a test” the infant DS system.)

<sup>88</sup> Intuitively, the availability and quality of the negotiated flexibility mechanism(s) has an immediate impact on contractual misdemeanor by potential injurers: Whenever permissible behavior is mis-specified, when *intra-contractual* remedies are too high, or when legal means of escape are unavailable, injurers under protectionist pressure may look for legal loopholes. They may resort to *extra-contractual*, illegal actions, either hoping not to get caught, or because they expect the subsequent punishment to be smaller than the expected gains from non-performance. This dynamics between *intra-* and *extra-contractual* behavior has reverberations on the extent to which a country agrees to liberalize its trade in the first place: A Member’s willingness to cooperate is a direct reaction to the quality and design of the contractual system of non-performance. If a country is not allowed to react to unforeseen developments in a certain industry or sector, it may not be willing to liberalize that sector *ex ante*. Similarly, if a WTO Member expects to be compensated inadequately for suffering from another Member’s protectionist backtracking, the former will equally be hesitant to liberalize at all.

non-performance (enforcement of international legal violations) on the other (see discussion in footnote 52 and corresponding text).

The compliance approach, on the other side, neglects issues of trade policy flexibility. Neither does it address the systemic connection between escape and enforcement mechanisms, nor does it give any systemic reasoning why *all* entitlements the WTO features are (or should be) protected by a PR of flexibility, and why Art. XXVIII GATT is ultimately no more than a liability rule (cf. discussion around footnote 61).

### ***Lesson 3: The tertiary rules of contracting – Protecting the contract***

In contrast to what rebalancing theorists may claim, and as a matter of contractual logic, enforcement and escape mechanisms should never be substitutes. Treating illegal behavior just like cooperative action is not only morally dubious. Using defection from the agreed-upon rules as an *ex post* flexibility tool is also inefficient and irrational, since it strips signatories of any chance to effectively sanction ill-meaning opportunistic behavior (cf. discussion around footnote 52).

The compliance camp perceptively stresses the strict difference between trade policy flexibility instruments and WTO enforcement. However, as our discussion in section 3.2 showed (cf. corresponding text around footnote 56), textual interpretations cannot make up for a lack of systemic intuition: Compliance advocates owe an answer as to why the current WTO enforcement is so “toothless”, despite its alleged mandate to induce compliance with the rules of the game and the rulings of dispute panels.

### ***Lesson 4: More effort should be put into ways of reforming the WTO***

The entire compliance/rebalancing debate was fought on the battlefield of “how to interpret the treaty language on object and purpose of WTO enforcement?”. We argued extensively why the exclusive focus on enforcement is unwarranted and indeed myopic. Furthermore, we take issue with the emphasis on what the WTO *is*, *does*, and *says*. It seems much more pertinent to enquire what the WTO is *conceptualized as* and how to best *reform* the current system of non-performance, i.e. the current rules of trade policy flexibility and enforcement.

Two reasons motivate this contention: First, WTO Members are experiencing significant discontent with the WTO’s current institutional framework. Many WTO signatories have addressed profound concerns about the existing system of flexibility, dispute settlement, enforcement and the available enforcement instruments (see footnote 2 above). Second, we believe the current system of escape and punishment to be seriously flawed in many ways. Without going in great detail, let us provide a summary of the major shortcomings of the current WTO regime of non-performance (the interested reader is referred to Mahlstein and Schropp 2007, section B.3, Schropp 20078, section 5.4, and Roitinger 2004):

- **The *de iure* system of protection of the market access entitlement is incoherent and insufficient.** The WTO provides a whole arsenal of formal (*de iure*) trade policy flexibility



mechanisms which allow for *ex post* escape from the market access entitlement.<sup>89</sup> Common to these *de iure* flexibility mechanisms is a rather high level of conditionality (enactment preconditions and scope of application), as well as relatively modest indemnity payments for the affected victim countries.

One concern is that these formal escape mechanisms can often be used interchangeably, since they are all variations of a liability-type rule of escape. Another concern is their lacking scope: Many scholars argue that *de facto* violations of WTO obligations frequently occur because of the rigidity connected to the enactment of formal escape mechanisms. The current WTO safeguards regime does not provide Members with the necessary “breathing space”.<sup>90</sup> Next, *intra-contractual* remedies have been systematically under-compensatory. As per GATT Arts. XVIII.7.b, XIX.3.a, or XXVIII.3.a/4.d, the WTO mandates *intra-contractual* remedies to be “substantially equivalent” to the damage done. Pursuant to Art. 22.6 DSU, it devolves upon WTO arbitration panels to interpret what *substantial equivalence* means: By granting *prospective* remedies amounting to *direct trade damages*, WTO arbitrators have interpreted *equivalence* to roughly imply the re-establishment of the *status quo ante* the breach.<sup>91</sup> As Mahlstein and Schropp (2007, section D) have shown, a re-establishment of the *status quo ante* the breach is under-compensatory. It induces injuring Members to over-breach, a behavior that consequently crowds out cooperative zeal (*ex ante* trade liberalization commitments) on the part of the victim countries. Finally, the countermeasure of suspension of concessions (retaliation) is generally a questionable mechanism of remediation.<sup>92</sup> As is well known, the countermeasure of retaliation is a questionable, some would say nonsensical, mechanism of remediation.<sup>93</sup>

- **Uncertainty how non-market access entitlements are protected.** Turning to the protection of non-trade obligations traded in the WTO (minimum standard and auxiliary entitlements), our criticism is the absence of a clear and unambiguous fallback rule of entitlement protection: *Quid* in case a situation occurs that is not anticipated in the letter of the contract? The Marrakech Agreement is largely mute on that issue. Article X on treaty amendments could be seen as some sort of a flexibility rule: It explains the specific procedure to be followed

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<sup>89</sup> Examples in the GATT are Art. XII (*Restrictions to Safeguard the Balance of Payments*, applicable only to developed countries), Art. XVIII (infant industry protection and balance of payments crises; applicable to developing countries only), Art. XIX, Art. XX (*General Exceptions*), Art. XXI (*Security Exceptions*), and Art. XXVIII. Similar examples of trade policy flexibility instruments can be found in other WTO Agreements, such as the GATS, TBT, or the Agreement on Agriculture.

<sup>90</sup> See Horn and Mavroidis (2003), Skyes (2003), Roitinger (2004). Footnote 87 gave a concrete example.

<sup>91</sup> In constructing a counterfactual situation that would prevail if the illegality were removed (Sebastian 2007, p. 351), WTO arbitrators have awarded damages which are apt to restore the trade level that would exist, had the injurer brought its contravening measure into conformity after the reasonable period of time (see also Mavroidis 2000, Lawrence 2003, Breuss 2004, Spamann 2006).

<sup>92</sup> Most *de iure* flexibility mechanisms couple *ex post* escape with the *intra-contractual* remedy instrument of tariff compensation offered by the injurer to the victim(s) of a backtracking measure. However, if compensation negotiations break down, the victim is authorized to engage in retaliation.

<sup>93</sup> Anderson (2002) finds five distinctly economic, Araki (2004) eight general disadvantages of the countermeasure of retaliation. Most compellingly, a retaliating victim country “shoots itself in the foot” (Mavroidis 2000) when avenging the injurer’s unlawful trade protection by raising trade barriers on its part: Retaliating is inefficient, harms consumers and downstream industries, and in addition makes import-competing industries complacent and slack (Subramanian and Watal 2000 at p. 406 note: “Under most circumstances, the implementation of trade retaliation leads to a decline in economic welfare of the retaliating country; cf. also Breuss 2004, Spamann 2006, Trachtman 2006).

whenever a Member tables a proposal to amend any Agreement mentioned in Annex 1. However, as Mavroidis (2007, p. 547) notes, the WTO – in contrast to the VCLT – does not distinguish between *amendments* and *modifications*. Amendments are once-and-for-all changes of the treaty language, whereas modifications bear a more temporary, intermittent and discretionary connotation. Hence, the WTO Agreement is effectively mute on the issue of temporary *ex post* escape.

- **The *de facto* trade flexibility tools cancel out legal escape mechanisms.** In addition to *de iure* escape clauses, there are various informal (*de facto*) flexibility tools available to WTO Members. Albeit in contravention of the letter of the law (or at least the spirit of the Agreement), trade policy tools such as voluntary export restrictions (VERs), ordinary marketing agreements (OMAs), antidumping (AD) and countervailing duty (CvD) measures, subsidies, domestic trade-related policies or a simple violation of the Agreement are often used by WTO Members as ways to escape initially made trade liberalization commitments.

While at face value the *de iure* system of trade protection privileges victims and exacerbates *ex post* discretion of potential injurers, the *de facto* system yields the complete opposite outcome. It seriously disadvantages victims of non-performance measures while favoring injurers. Given that these *de facto* trade policy flexibility mechanisms happen more or less in the shadow of the law, injuring Members profit from lower enactment costs, far-reaching scopes of application, less (to zero) enactment thresholds, and indemnity payments that are strictly lower than those pursuant to a legal opt-out.<sup>94</sup> In addition, informal trade policy flexibility tools are politically more convenient to policymakers (Ethier 2004, Schropp 2005). As a result, the *de facto* escape mechanisms in the WTO annul pretty much everything the WTO contract prescribes.

- **Violation-cum-retaliation as general fallback rule of escape.** By punishing legal and illegal behavior in the same fashion, the WTO contract to all intents and purposes establishes *violation-cum-retaliation* as the *de facto* fallback rule of non-performance. Violating the Agreement and subsequently losing the trade dispute is the *ultima ratio* for any Member who wants to opt out of its initially made concessions. That flexibility strategy is always available and at the same time is one of the most attractive options (Mavroidis 2000). This is consequential, because *violation-cum-retaliation* sets the benchmark for *all* other (formal and informal) escape remedies the WTO knows today. For example, it determines the power relationship in all settlement negotiations between injurers and victims: When bartering over voluntary compensation, no injurer will be willing to settle above its reservation utility, i.e. its expected cost of enduring retaliation.

The current system of trade policy flexibility and enforcement in the WTO is profoundly flawed. It is not too difficult to see that a rational injurer will always go for the very escape mechanism that

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<sup>94</sup> Under the current WTO enforcement regime, deliberately violating the Agreement is penalized *less* than resorting to *de jure* flexibility. This may sound like contractual illiteracy, but is an actual WTO fact. Consider the following: Both *intra*- and *extra*- contractual escape are sanctioned in the same way. The WTO jurisdiction has interpreted remedies to be roughly equivalent to the reestablishment of the *status quo ante* the breach (see footnote 91). However, remedies pursuant to the exercise of an informal opt-out are payable *only* if the victim Member sues and the injurer subsequently is found guilty of the violation. Thus, the remedy that an injuring country expects to incur is strictly smaller than that under any formal opt-out mechanisms. This is so because the injurer factors in (a) the probability that the victim may not go to court at all, (b) the possibility that the injurer may actually win the litigation, (c) that the case be suspended over legal formalities, (d) the certainty that trade damages are awarded *prospectively*, and (e) the probability that the victim country may refrain from enacting its retaliation award.

promises the “most mileage”, i.e. the least enactment costs, the lowest compensation payable to the victim, and the broadest scope of application. With a variety of informal flexibility tools at its discretion, any injuring WTO Member can renege on the rules of the game at its discretion and practically for free. Alternatively, it can simply infringe upon the treaty at the price of losing a trade dispute and having to pay the WTO arbitrator’s estimate of damages, which – in expected terms – is strictly less than the amount owed to the victim under a formal safeguard. *Violation-cum-retaliation* is the ultimate fallback rule of flexibility. No matter what the various WTO Agreements may say, the current non-performance regime is tantamount to a *pure LR with the court’s interpretation of remedies equivalent to the harm done*. This sets strong incentives for injurers to simply disregard the rules of the game.

To conclude, the way non-performance currently functions cannot possibly have been the WTO framers’ intention. But in order to reform the system of trade policy flexibility and enforcement, WTO scholarship needs a clearer idea of what the WTO was initially conceptualized as, and was meant to achieve in the first place. Without an adequate theoretical framework any discussion of WTO reform must be seen as futile.<sup>95</sup>

***Lesson 5: The only real bone of contention between rebalancing and compliance advocates is the optimal protection of the market access entitlement***

An interesting insight from our analysis in section 4 is that the only direct disagreement between the compliance and rebalancing camp lies in the question how the reciprocal market access entitlement is to be adequately protected in the event of unforeseen contingencies:<sup>96</sup> Compliance scholars, on one side, claim that efficient non-performance can be induced by means of a renegotiations clause, e.g. pursuant to Art. XXVIII GATT. Rebalancing proponents, on the other side, advocate for a LR-type opt-out along the lines of Art. XIX or, if explicit contingency measures are inapplicable, along the lines of *violation-cum-retaliation*.

As mentioned before (footnotes 39-41 and corresponding main text), we believe it to be quite clear that the letter of the WTO treaty today forestalls such rebalancing interpretation of the DSU; *violation-cum-retaliation* effectively constitutes a breach of international law, yet presents a very realistic escape option to WTO Members. A more pertinent question is whether the reciprocal market access entitlement *should optimally* be protected by an unconditional liability rule, or a rule of renegotiation.<sup>97</sup> But apart from this one point of contention, compliance and rebalancing advocates have really focused on entirely different aspects of the WTO contract, as the next point will illustrate.

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<sup>95</sup> Sykes 2000, p. 348 confirms: “[I]t is important to understand what [institutional framework] WTO members have fashioned for themselves. If we are to theorize successfully about the rules of the game, we must understand the *nature* of those rules at the outset.”

<sup>96</sup> Note that the compliance and the rebalancing paradigm are not in conflict on any other issue because of their selective discussion of the WTO contract (see Chart 1 above): The rebalancing school considers neither non-market access obligations, nor aspects of contract enforcement, while compliance advocates focus exactly on enforcement matters.

<sup>97</sup> This is not the place to delve deeper into this topic. The interested reader is referred to Mahlstein and Schropp (2007), who model the WTO as an incomplete tariff liberalization treaty. Comparing different trade policy flexibility regimes (including an inalienability rule, a property rule, and various liability arrangements), the authors find evidence that the market access entitlement is best protected by a liability rule accompanied by expectation damages.

### ***Lesson 6: Rebalancing and compliance proponents may both have it right***

By logically separating issues of trade policy flexibility from those of enforcement, by isolating the discussion of multilateral non-trade entitlements from that of reciprocal market access commitments, and by concentrating on the nominal instead of the actual state of affairs, we come to the surprising conclusion that *both* views may have it right. A rebalancing of concessions, as well as inducing compliance with the rules of the game may very well be fundamental pillars of a reformed WTO contract: Whereas the compliance view delivers important realizations about the presence of multiple entitlements and the need for protecting all entitlements from *ex post* defection, the rebalancing view raises attention to the need for integrating trade policy flexibility into the systemic whole and for re-equilibrating market-access infringements. Both perspectives may in fact be extremely helpful in shedding light on different facets of the issue and provide us with valuable conclusions concerning the structure and logic of the contract. This would make the WTO both a compliance- *and* a rebalancing contract.

In order to confirm this conjecture, more research needs to be conducted, which examines the nature of the WTO Agreement, and its optimal system of flexibility and enforcement. A research agenda of this kind is laid out below.

### **5.2 Proposal for a unified research agenda**

Six lessons were drawn from the critical examination of the compliance/rebalancing debate. An important outcome is that none of the two schools of thought can grasp the real nature of the WTO, let alone motivate a convincing reform agenda. Yet by having made explicit the largely implicit perceptions about the nature of the WTO contract which underlie each of the two camps (cf. Charts 1 and 2), we have shown that the two schools of thought are hardly in opposition at all. In fact, they are pieces to the same jigsaw puzzle. Since the two views are highly complementary, there is the opportunity to capitalize on the insights of both schools and to draft a unified research and reform agenda of the WTO. This research agenda could simply consist of three steps:

- 1) Understand the rationale for contracting and the entitlements exchanged;
- 2) Suggest reforms of the WTO system of trade policy flexibility by assessing the optimal entitlement protection mechanism for every type of entitlements exchanged;
- 3) Suggest reforms of the current system of enforcement by crafting viable sanction mechanisms.

This agenda addresses the same three basic stages of contracting that we stressed throughout this paper: the primary, secondary, and tertiary rules of contracting. As we have argued in section 4, this suite of research questions implicitly or subconsciously was at the core of the compliance/rebalancing debate all along. Putting it at center stage appears to be a promising way forward to effectively reform the system and to reconcile the two rivaling schools of thought.

#### ***5.2.1 Understand the nature of the contract and entitlements exchanged***

As a necessary first step, it is paramount that WTO scholarship better understands what really drives sovereign countries to cooperate in trade matters, and that it identifies in all detail the nature of the exchanged entitlements.

No examination of a contract is complete – and no reform proposal credible – without a clear conception of what initially motivated signatories to cooperate and to subsequently strike an

agreement in the form of a written treaty. Unfortunately, trade scholarship is still far from establishing a convincing answer as to why sovereign countries engage in trade cooperation at all (cf. Mavroidis 2007, section 1.2.5; Schropp 2008, section 4.1.3, WTO 2007, section II.B.6). Whilst current economic, political, and legal approaches seem able to elucidate facets of countries' cooperative zeal, none is close to capturing the whole picture. More work needs to be done to produce testable results as to which rationale for contracting (or which combination thereof) best manages to explain countries' cooperation motivations. Formal economic work in particular should be welcome. Political economists should start thinking beyond the prisoners' dilemma set-up when trying to explain trade cooperation. WTO scholars should dedicate more energy into alternative collective-action games of strategy (such as co-ordination games or games of assurance).<sup>98</sup> Cross-disciplinary work seems a fruitful and promising avenue for future research.

Pauwelyn (2006) perceptively states that the body of rules and obligations that constitute the WTO treaty, comprises of more than just reciprocal market access entitlements. However, while much work in WTO scholarship has concentrated on the reciprocal exchange of market access and tariff liberalization concessions,<sup>99</sup> it is remarkable that research on the multilateral entitlements exchanged in international trade agreements is scarce. Above, we proposed a tripartition in market access-, minimum standard- and auxiliary entitlements. The important distinction hereby is that the market access entitlement is bilaterally owned, while the other entitlements are *erga omnes partes* entitlements that are owed to the membership as a whole. Of course, other classifications are possible and more work along these lines seems desirable.

### 5.2.2 Design trade policy flexibility mechanisms

Only once WTO scholars have disentangled and categorized the fundamental entitlements exchanged in the treaty (the primary rules of contracting), they can proceed to tackle the issue of how *ex post* discretion should be exercised, i.e. how *each* commitment is best protected against instances of post-contractual backtracking (the secondary rules of contracting).

In general, an ideal entitlement protection mechanism follows the principle of Pareto efficiency: Contractual concessions should only be escaped from if doing so is globally welfare-enhancing (Barton 1972, Shavell 1980, Rogerson 1984, Posner 1988). However, not every entitlement is best protected in the same way: The market access entitlement may be optimally protected by an unconditional liability rule and backed by expectation damages (as Sykes 1991, Ethier 2001, Herzing 2005, Rosendorff 2005, Mahlstein and Schropp 2007 claim). Other entitlements, however, may require different flexibility designs, such as an inalienability rule, a renegotiations clause, or a liability rule accompanied by lower *intra*-contractual remedies.

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<sup>98</sup> Most theories of trade agreements root their explanation of trade agreements in the presence of an international prisoners' dilemma (cf. footnote 12 above). This reduces trade cooperation to a *collaboration* problem (cf. Stein 1983, Martin 1993). However, contracts can also be concluded with the aim of solving *assurance* or *coordination* games (cf. Sandler 1992, Aggarwal and Dupont 1999, Ostrom 2003, Aggarwal and Dupont 2004). Unfortunately, this issue is largely unstudied in the trade literature, specifically in what respects trade agreements can be conceptualized as *coordination* games and the impact this would have on their optimal design (see also WTO 2007, chapter II.B.2.a). Indeed, the TRIPS, TRIMS or ILP Agreements could be seen as accords aimed at solving coordination problems (see Schropp 2008, section 4.1.2.5).

<sup>99</sup> In fact, as we showed in Section 2.1, the rebalancing approach to the WTO contract, which most economists subscribe to, is exclusively concerned with the market access entitlement.

The choice of the efficient protection rule depends on a variety of variables, such as the nature of the entitlement, its exposition to external shocks, possible information asymmetries, and the damage that *ex post* discretion may provoke in victim countries. Entitlements are best protected by an inalienability rule, for example, whenever *ex post* non-performance is immoral, contract-annihilating, or unambiguously welfare-depreciating.<sup>100</sup> More lenient remedies may be apposite whenever the exercise of *ex post* discretion causes minor damage.<sup>101</sup>

More and detailed research with respect to entitlement protection seems warranted. WTO scholars should make efforts to break down the entitlements traded in the WTO, and to assess every (group of) WTO entitlement(s) individually for its optimal *ex post* escape rule and corresponding *intra*-contractual damage remedy.

### 5.2.3 Design efficient rules of enforcement

Last but not least, WTO scholars should reflect on how to reform dispute settlement procedures and enforcement instruments. In general, any workable system of contract enforcement should be able to separate good-faith clashes resulting from textual ambiguities, ambivalent formulations, omissions, erratic provisions and opposite interpretations, from bad-faith clashes motivated by sheer opportunistic guile. To that end, WTO enforcement ought to possess a separate *dispute resolution*- and a *punishment* stage.

An amicable dispute resolution stage seems essential: Clarifying contractual ambiguities and filling inadvertent contractual gaps has an intrinsic positive value for the WTO membership as a whole. Eliminating haphazard gaps leads to transaction cost efficiencies and makes trading easier and more predictable (see generally Keck and Schropp 2007). Hence, the institutional framework should encourage signatories to bring these issues to light, and should not dispirit Members from openly questioning problematic or erratic provisions. There seems to be consensus in the literature

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<sup>100</sup> See Schropp (2008, section 3.3.1). *Ex post* default is *immoral* with respect to certain external entitlements, such as *ius cogens* norms (see footnote 86 above). Peremptory norms of international law supersede every treaty provision in international law and sovereign countries must neither “contract around” them nor deviate from these entitlements *ex post*. Contractual escape is *contract-annihilating* whenever a unique level of commitment is indispensable for the functioning of the contract. This is typically the case in instances where the exercise of *ex post* discretion can be used to completely and irreversibly abrogate the terms of the accord. Consider the example of international arms control agreements, such as the Strategic Arms Limitations Treaty (SALT), or the Treaty on Anti-Ballistic Missiles (ABM): Anything else than a rule of inalienability would frustrate the essence of these agreements and crowd out cooperative zeal *ex ante* (Rosendorff and Milner 2001, p. 830). No country would accede to SALT or ABM if these contracts posited that any Member may temporarily opt out of the agreement, whereby “temporary” contractual escape would be tantamount to canceling the respective treaty altogether.

<sup>101</sup> Take instances, such as an overstepped deadline, an omission to report or notify or the late payment of a WTO membership fee. These administrative or regulatory offences may be perceived as petty infringements in the grand scheme of things. They cause minor nuisance to the world trading system as a whole, and hardly affect any one contracting party in special. An entitlement protection in the form of an IR or PR thus may not seem warranted, simply because the transaction costs connected to lengthy renegotiations or litigations easily outweigh the damage done. Yet infringements should not be ignored, either. Therefore, punishing misdemeanor by means of pre-assigned liquidated damages may be apposite.

that the legal framework of the DSU does a good job at clarifying ambiguities and resolving disputes harmoniously (see Davey 2005, WTO 2007, section II.D.3).<sup>102</sup>

Once the chance for an amicable resolution of the conflict has lapsed, contract theory would mandate strict enforcement in the subsequent punishment stage. Enforcement should have “teeth”, since the risk remains that non-compliant Members blatantly disregard their duty to bring the contested measure into compliance with the panel/AB report, or to compensate the victim(s) of protectionist backtracking. From a contract-theoretical perspective there is no inherent reason why enforcement of defective behavior should remain within a “rebalancing” logic, or why a dispute should be kept bilateral. *Extra*-contractual remedies in this second stage of enforcement could well be *coercive* in nature. Punitive damages are conducive to protect the previously agreed rules of the game (including *intra*-contractual escape possibilities), to induce compliance with the panel ruling as quickly as possible, and to deter *extra*-contractual bad-faith behavior by future injurers.

How effective punishment can be put to work has been the subject of many fine contributions by WTO scholars and practitioners. Two propositions seem most promising: One is collective enforcement, in which retaliation leaves the bilateral realm of complainant-vs.-defendant. Under collective enforcement, retaliation becomes an issue of concern to the entire WTO membership. Complaining, affected and concerned parties alike gang up on the perpetrator and pool their retaliation capacities. By so doing, single victims can overcome the problem of constituting too small a market to cause noticeable pain to the injuring Member.<sup>103</sup> Enforcement, hence, may become a real “sanction” to speak of, since it is free from any rebalancing constraint, and does not bear a bilateral notion.

A second proposition towards giving substance to enforcement is the suspension of certain Membership rights, such as the right to attend meetings, to use the DSM, or to receive technical assistance. The positive aspect of the suspension of Membership rights is that they do not entail negative trade effects. Experiences in that area have already been gathered in the IMF, the Montreal Protocol for the Protection of the Ozone Layer, and the ILO (Charnovitz 2001, Lawrence 2003).

Other enforcement reforms, such as strengthening cross-retaliation,<sup>104</sup> tradable remedies (Bagwell et al. 2005, and Limao and Saggi 2006) or certain soft-law reforms (see Chayes and Chayes 1993, Mitchell 1993, Charnovitz 2002b, Guzman 2002) are also possible, since they are all conducive to inducing compliance with the (reformed!) rules of the game.

Chart 3 summarizes what a unified research agenda could look like.

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<sup>102</sup> However, some commentators (e.g. Pauwelyn 2000, Horlick 2002, Lawrence 2003, Schropp 2005, Bagwell 2007) criticize the relative neglect of the countermeasure of tariff compensation in the DSU (“compensation is a rare event” as Pauwelyn 2000 at p. 337 states). Compensation is procedurally disadvantaged and has only once been applied in the WTO (*US – Section 110(5) of the US Copyright Act*; WT/DS 160).

<sup>103</sup> India and nine other developing countries expressed the need for a collective retaliation scheme along the lines of the “principle of collective responsibility” championed in the UN Charter (TN/DS/W/19; academic support is provided by Maggi 1999, Pauwelyn 2000, Hudec 2002 ).

<sup>104</sup> Strengthening the use of cross-retaliation seems a feasible way forward. Yet in order to make cross-retaliation a workable tool, the DSB’s restrictive, “superficial and inconsistent” (Hudec 2002, p. 90) interpretation of Art. 23.3(c) DSU, originating from the *EC – Bananas* adjudication, ought to be revised.

**Chart 3: Towards a unified reform agenda**

School of thought Contracting stage	Unified approach: <i>Rebalancing-cum-compliance</i>	Rebalancing approach	Compliance approach	Inalienability approach
I Initially exchanged entitlements	<input type="checkbox"/> Market access <input type="checkbox"/> Minimum standard <input type="checkbox"/> Auxiliary	Market access commitments	n.p.	Trade liberalization commitments
II <i>Intra-contractual</i> entitlement protection	Depending on the nature of each traded entitlement: <input type="checkbox"/> Liability rule <input type="checkbox"/> Property rule <input type="checkbox"/> Inalienability rule	Liability rule	Property rule	Inalienability rule
III Enforcement: <i>extra-contractual</i> entitlement protection	<input type="checkbox"/> Lenient in dispute stage (good-faith clashes) <input type="checkbox"/> Coercive in punishment stage (bad-faith clashes)	n.p.	Coercive punishment	Coercive punishment

Source: author

Notes: This is an extended version of Chart 1. A unified perspective of the nature of the WTO (grey column) may motivate an integrative and comprehensive agenda for reform, and may even reconcile the three competing perspectives on the nature of the WTO treaty.

We believe that a research agenda along the lines of the primary, secondary and tertiary rules of contracting may offer many worthwhile research avenues for trade lawyers, economists, and international relations scholars alike. As Chart 3 shows, our proposed research agenda contains elements of all three approaches to the WTO – the compliance-, rebalancing- and the inalienability school of thought. Within our framework all three perspectives of the WTO have merit; they are vital to explaining the nature of initial commitments, and the optimal entitlement protection against *intra-* and *extra-contractual* non-performance. This integrative research agenda may induce scholars and practitioners to leave behind the old compliance/rebalancing controversy and work towards a common goal: The successful reform the WTO system of trade policy flexibility and enforcement.



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