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Peculiarities of retaliation in WTO dispute settlement

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Abstract: The dispute resolution procedures of the World Trade Organization allow sanctions to be imposed when a country is unwilling to bring a WTO-inconsistent trade measure into conformity. Apart from the fact that the procedure for triggering the retaliation process has ambiguities that need to be removed, the retaliation itself has some undesirable economic features. This paper looks at why compensation is not preferred to retaliation and then examines five economic features of the temporary trade retaliation that WTO may permit under certain conditions. Both efficiency and equity concerns are raised. The paper concludes with some suggestions for reforming this part of WTO dispute resolution during the review of the Dispute Settlement Understanding that is due to be completed by May 2003.

One of the major achievements of the Uruguay Round of multilateral trade negotiations was the creation in the new World Trade Organization of a much-enhanced dispute settlement mechanism.¹ Known formally as the ‘Understanding on Rules and Procedures Governing the Settlement of Disputes’ (WTO, 1995), this body of international trade law raised great expectations of much more definitive and speedier resolution of trade disputes than under the law of the original General Agreement on Tariffs and Trade (GATT). Even so, the possibility remains that a WTO member found to have WTO-inconsistent policies may choose not to reform those policies enough to satisfy complainants. If in that case a WTO Panel finds the new policies still inconsistent with WTO rules, the complainant country is entitled to compensation. Should an agreement on compensation not be forthcoming there is provision, in Article 22 of the Dispute Settlement Understanding (DSU), for the complainant to retaliate against the respondent. If the extent of retaliation is not agreed between the parties, an arbitrator will determine the amount. The first two

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¹ Jackson (1998, p. 176) went so far as to claim that the establishment of the Dispute Settlement Body in the WTO ‘is likely to be seen in the future as one of the most important, and perhaps even watershed, developments of international economic relations in the twentieth century’.

uses of that provision were in the late 1990s (bananas and beef hormones) and involved the two largest WTO members: the United States, as one of the complainants, and the European Communities, as respondent.²

This provision to retaliate and the rules for doing so involve an apparent procedural dilemma as well as some peculiar economic features. Now is the time to reconsider those features of the rules, because the DSU has been under review as part of the Uruguay Round's built-in agenda and is now also part of the multilateral trade negotiations launched in Doha in November 2001, which involves a commitment to reach agreement on DSU improvements and clarifications no later than May 2003.

The present paper discusses first the apparent dilemma in the procedure for triggering the retaliation process, then asks why compensation is not preferred to retaliation, and then examines five economic features of retaliation. Those features are the concept of equivalence, the inherent injustices that remain, the choice of counterfactual to the WTO-inconsistent regime, the appropriate breadth of coverage in the damage calculations, and the cross-retaliation issue. The paper then points to the complications that globalization is adding to trade dispute resolution. Some implications for reforming the WTO's dispute settlement procedures are drawn out in the final section.

1. The problem with the triggering process

If a WTO dispute settlement Panel or the WTO Appellate Body finds a member's trade policy to be not in conformity with WTO rules and the member's commitments, a 'reasonable period of time' is allowed for the policy to be brought into conformity (DSU Article 21.3). In practice this period has ranged from three to 15 months. If the policy is not changed, consultations between the complainant and respondent members should begin before that time period expires, with a view to establishing mutually acceptable compensation. If no satisfactory agreement is reached within 20 days after expiry of the 'reasonable period of time', the complainant(s) can request authorization from the WTO's Dispute Settlement Body (DSB) to 'suspend concessions', that is, to retaliate (DSU Article 22.2).

Unless there is a consensus not to, the DSB will grant that authority, and within 30 days after expiry of the reasonable period of time. Should the respondent object to the amount of retaliation proposed by the complainant, the matter is referred to an Arbitrator for a decision within 60 days after expiry of the reasonable period of time (DSU Article 22.6). The task of the Arbitrator (where possible the original Panel that ruled on the WTO inconsistency in the first place) is to decide whether the level of retaliation proposed is 'equivalent' to the level of damage ('nullification or impairment'). That decision by the Arbitrator is final: there is no appeal option or

² There were no GATT-authorized retaliatory measures imposed during the 47 years prior to the formation of the WTO in 1995. In the one case where it was authorized, for the Netherlands in 1952, the authorized quota was never put in place (Valles and McGiven, 2000, p. 77).

opportunity to seek a second arbitration. The DSU will accept the decision and grant authorization for retaliation, again unless there is a consensus not to (DSU Article 22.7).

Straightforward as that procedure may seem, it hides an apparent dilemma in the DSU. Suppose the respondent takes the full 'reasonable period of time' before announcing a reform of the offending policy measure. If the complainant believes the reform is insufficient to make the policy WTO consistent, there is the opportunity to refer the matter to a Panel (again, preferably the original one). The Panel in turn must report within 90 days of that request (DSU Article 21.5). If the respondent is unhappy with the Panel's ruling, another 45 days could be required for the Appellate Body to consider the matter. The apparent dilemma is that even if the Panel or Appellate Body find the reformed policy still WTO inconsistent, the 20 days after the 'reasonable period of time' for a complainant to lodge a request to retaliate will have expired. This interpretation of DSU Articles 21.5 and 22 suggests there could be an endless loop of litigation.

An alternative interpretation is provided by Mavroidis (2000, pp. 795–799). He argues (a) that Article 22.2 includes the possibility that the losing party does nothing to bring its measures into compliance, in which case there is a 20-day deadline to request countermeasures, and (b) that Article 21.5 deals with the situation where the losing party does something to bring its measures into compliance and there is disagreement as to the adequacy of that reform, in which case the 20-day period to request countermeasures starts at the end of the Article 21.5 (Panel or Appellate Body) proceedings if the finding is against the respondent. With this interpretation there is no dilemma in law: the compliance Panel's mandate under Article 21.5 is simply to decide if the reform is adequate. If so, end of story; if not, the complaining party can request countermeasures.

Even this second interpretation leaves open the possibility for a respondent to make an endless series of inadequate reforms – although the retaliatory measures would remain in place until the complainant or a Panel is satisfied with the reform. Clearly that possibility of very prolonged resolution could be tightened up through a re-drafting of the procedural rules when the DSU is reviewed.³ The problem is now well recognized by the WTO membership, and suggestions for remedial action have been forthcoming.⁴ Hence attention now turns to the economic features of compensation and retaliation in cases where a policy measure has been found to be still WTO inconsistent.

³ The various aspects of the sequencing problem that need to be reviewed, and the approaches adopted in the interim by other Panels, are laid out by two Canadian officials in Valles and McGiven (2000). For discussions by other trade law professors of how the WTO Panel and Arbitrator handled this dilemma in the case involving the EC banana import regime, see Salas and Jackson (2000), Bhala (2000) and Komura (2000).

⁴ Mavroidis (2000, p. 799), for example, suggests three points for consideration by the DSU review: that a request for countermeasures can be examined only if a compliance panel has previously pronounced the implementing action inadequate; that the compliance panel decision is final (not appealable); and that respondents have only one 'reasonable period of time' to bring their measures into compliance with their WTO obligations.

2. Why is compensation not preferred to retaliation?

A complainant unhappy with the respondent's policy reform is entitled to seek compensation until satisfactory reforms are implemented. If that compensation comes in the form of a temporary lowering of the respondent's import barriers on some other products, the changes must be consistent with existing agreements. In particular, they must be offered on a most-favoured-nation (MFN) basis.

In pure economic terms, compensation in this form is simply trade liberalization. That boosts economic welfare in the respondent country, in the complainant country, and even in third countries that export the products whose import barriers have been lowered. Even if some third countries that import those or like products were to lose from a terms-of-trade deterioration, we know from standard gains-from-trade theory that the world as a whole will be better off economically.

Why, then, is compensation rarely preferred to retaliation, when the latter typically involves the complainant raising its import barriers on products exported by the respondent and thereby harming economic welfare in *both* countries and globally?

The answer has at least three parts. First, for reasons discussed in the previous section, the current procedures do not guarantee a timely arbitration decision on the extent of compensation that is warranted. Hopefully that will not be an issue if/when the procedural rules in Articles 21.5 and 22.6 of the DSU are amended following the review currently under way.

Second, the MFN feature of compensation means third countries also could export more to the respondent, so the complainant would require a larger degree of access than if access were able to be provided on a preferential basis. Even though that greater openness would improve economic welfare for the respondent country, the political economy of trade policy is such that the political leadership of the country would lose from such unilateral reform – otherwise it would not have those import barriers there in the first place (Grossman and Helpman, 1994).⁵

And third, if compensation were to be granted, the respondent would gain greater control of procedures. Specifically, since the compensation is voluntary (DSU Article 22.1), the respondent can end it once the offending policy is further reformed, pending the protracted outcome of any further action by the complainant under DSU Article 21.5. With retaliation, by contrast, the complainant can keep that pressure on the respondent until the latter satisfies an Article 21.5 Panel that the proposed replacement of the offending policy is WTO-consistent and the new measure has been implemented satisfactorily.

⁵ The fact that bilateral and multilateral agreements to lower import barriers are reached does not contradict the fact that governments are unwilling to liberalize unilaterally. Those agreements can be seen as a form of political gain from exchange in market access: Country A allows more of B's exports into A's market on the condition that B allows sufficiently greater access to its market for A's exports that the leadership in each country gains at least as much extra political support from its exporters (and consumers) as it loses from its import-competing producers who are exposed to greater competition from abroad (Grossman and Helpman, 1995; Hillman and Moser, 1995).

This is not to say that retaliation is desirable from the complainant's viewpoint. On the contrary, it is a last-resort action with peculiar economic features, five of which are considered below.

3. Five features of the economics of trade retaliation

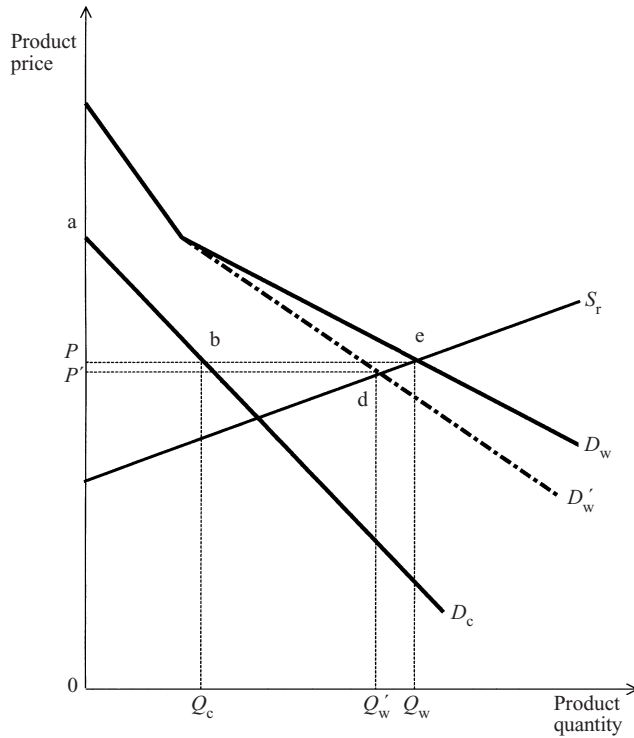
The concept of equivalence

As noted above, DSU Article 22.7 requires the Arbitrator to determine whether the level of retaliation for which authorization is being sought is 'equivalent' to the damage caused by the WTO-inconsistent measure. The type of retaliation most commonly considered involves the complainant listing a range of products it imports from the respondent on which it will impose prohibitively high tariffs until the respondent's offending measures are brought into conformity. The gross value of the imports to be prohibited, typically the average for the three most recent representative years for which import data are available, should match the value of the complainant's imports excluded by the respondent's WTO-inconsistent measure. That is probably the simplest way of quantifying the on-going damage to the complainant from the WTO-inconsistent part of the respondent's policy measure when that measure is an excessive import restriction.

However, it needs to be recognized that ensuring equivalence between the damage and the retaliation in terms of the gross value of trade between the respondent and the complainant does not mean that retaliation has the same *economic welfare* effect on the respondent as the initial damage is having on the complainant. The bilateral trade value necessarily exaggerates the negative effect on both parties' economic welfare, but it does not do so equally (except by coincidence).

To see this, consider the case of retaliation depicted in Figure 1. Suppose D_c is the complainant's import demand curve for a product imported from the respondent, and D_w is the world's import demand for it. If S_r is the respondent's excess supply curve for that product, then, in the absence of distortions and assuming perfect competition, the international price of the product will be P and the quantity traded will be Q_w , of which Q_c goes to the complainant. A prohibitive tariff which reduces Q_c to zero will cause the global demand for the respondent's exported product to shrink to D'_w . This horizontal shift will be by less than the full extent of D_c because the complainant will demand more close substitutes in the world market, driving up their price and hence shifting out to some extent the demand curve of the rest of the world for the respondent's export product. The international price of that product will fall to P' and the volume of the respondent's exports will fall from Q_w to Q'_w , that is, by less than $0Q_c$. The gross value of the imports to be prohibited is the area PbQ_c0 , whereas the respondent's net loss of export earnings from this product is the smaller area $PeQ_wQ'_w dP'$. Meanwhile, the respondent's economic welfare loss because of that trade prohibition is just area $PedP'$, since the area under the respondent's export supply curve between points d and e represents costs of

Figure 1. The international market for a product that was imported by a complainant from a respondent being retaliated against



production which would not be borne if the respondent's export volume was reduced by $Q'_w Q_w$.

The economic welfare loss to the respondent is larger absolutely, and relative to the gross value of trade curtailed, the steeper (i.e., the less price elastic) is S_r , the respondent's export supply curve, between the free market equilibrium point e and the constrained equilibrium point d . Hence the ratio of $PedP'$ to PbQ_c0 would vary across products. This underscores the point that ensuring the reduction in the value of imports from the respondent, due to retaliation, matches the reduction in the value of imports from the complainant, due to the WTO-inconsistent measure being used by the respondent, will not be (except by coincidence) the same as ensuring equivalent losses in economic welfare for the other party due to the import restriction each is imposing.

Moreover, this retaliation is not costless to the complainant: it loses area abP in Figure 1 from choosing to forego purchasing those import products from the respondent. That economic welfare cost is smaller the flatter (or more price elastic, e.g. because of the availability of close substitutes) is D_c , the complainant's import demand curve for the respondent's export product, to the left of b . It is also offset

somewhat by the gains from trading more with suppliers of close substitutes to the respondent's products (not shown in Figure 1) – although that necessarily is smaller than area abP , for otherwise the complainant would have been purchasing from those other supplying countries in the first place.

Although political sensitivity is likely to be the main criterion for selecting products to target, the net economic cost of retaliating to the complainant relative to the respondent would be lower the lower the listed products' export supply elasticity between e and d and the higher the complainant's import demand elasticity between a and b , *ceteris paribus*. That is, there is scope for the complainant to minimize its economic welfare loss from retaliating, just as there is scope for the respondent to mitigate its lost sales through diverting them to other countries.⁶

For all these reasons, trade loss equivalence would never translate into equivalent damage to economic welfare, except by coincidence – and necessarily the complainant will in addition lose economically during the retaliation period from the import restrictions it imposes on the respondent's trade.

More fundamentally, why does the DSU seek 'equivalence' anyway? On the one hand, the idea of legitimizing retaliation is contrary to the objective of reducing impediments to trade. On the other hand, if the purpose of the retaliation is to induce swift WTO compliance from the respondent, then perhaps some multiple of the damage is the optimal level of retaliation to impose. Even the *possibility* that some multiple of the damage might be authorized would reduce the tendency for members to persist with WTO-inconsistent policies.

The inherent injustice of retaliation

Presumably the equivalence concept draws on notions of fairness (with parallels in centuries-old international conventions on military wars), especially since large economies have more scope to use this procedure effectively than smaller economies. But that notion is violated under WTO retaliation rules in at least four respects. First, past wrongs go uncompensated. That is, trade retaliation under WTO only targets non-compliance after the 'reasonable period of time' has elapsed following a Panel or Appellate Body finding against a respondent's policy regime. The damage done in preceding years to the complainant's export industry is simply ignored by DSU procedures.

Second, when the remedy chosen is a withdrawal of concessions by the complainant towards the respondent's exports, the complainant's economy is not helped but harmed by retaliation (the standard cost of protectionist barriers). For small or developing economies confronting a much larger trader, that may well deter them from seeking recourse through the DSU or, should the Arbitrator rule in their

⁶ Indeed the empirical evidence on past attempts to impose sanctions suggests the availability of close substitutes and the scope for circumvention mean such trade bans have much less economic impact than the gross value of trade might lead one to expect (see Hufbauer, Schott, and Elliott, 1990).

favour, from adopting retaliatory measures (as was the case with Ecuador following the decision reported in WTO, 2000).⁷

Third, retaliation does nothing to help the export industry that has been denied market access by the respondent in the first place.⁸ Rather, it is the complainant's import-competing industries that enjoy temporary assistance because of the prohibitive retaliatory tariffs imposed.

And fourth, the respondent's industries that are harmed by the complainant's retaliatory measures typically are not the industries that have been benefiting from the WTO-inconsistent measure. Rather, they are the ones chosen by the complainant typically with a view to having the largest negative political impact on the respondent government.

The choice of counterfactual to the present regime

To measure the export damage, the present WTO-inconsistent import policy regime needs to be compared with what it would be like once amended to become WTO consistent. This raises the obvious difficulty that many alternative policy measures, including even-more trade restrictive ones, could be WTO consistent. The respondent is unlikely to be helpful in suggesting what the alternatives might be, for one or other of them – including free trade – would have been implemented already if they were not so unattractive politically. That leaves the complainant with the task of proposing some counterfactual possibilities and estimating the damage under those various scenarios. The estimated damage is considered to be the difference in the value of the imports of this product set under the counterfactual regime(s) as compared with under the present WTO-inconsistent regime.⁹

The breadth of coverage

Only direct exports from the complainant to the respondent of the product(s) concerned should count. Indirect exports of the complainant's produce embodied in the final-good exports from another WTO member to the respondent are the concern of that third country – otherwise, its third-party rights would be violated (or, alternatively, there would be double counting of a portion of the damage to that third country's exports).¹⁰ If the product concerned is a service attached to goods from another country, then the complainant's trade would be measured at most from the f.o.b. point of that third country. It may go beyond the c.i.f. point in the

7 This is not to say that small countries would be better off without a multilateral dispute settlement process of course. On the contrary, Maggi (2001) provides a clear analysis of why bilateral agreements would be inferior from the viewpoint of small countries.

8 This point was made as long ago as the eighteenth century by Adam Smith (1776, Book IV, Chapter II).

9 For a clear description of how such a calculation is made, see the report of the Arbitrator in the case of the EC-US beef hormone case (WTO, 1999b).

10 Cases in point are the EC banana import regime arbitrations, whereby Ecuador was considered able to retaliate for loss of goods trade in the total value of bananas up to the f.o.b. point while the United States was not considered able to retaliate for loss of, say, fertilizer trade to Ecuador even though that fertilizer may have been used in producing Ecuadorian bananas that could have been sold to the EC. See WTO (1999a, para. 6.12) and WTO (2000).

respondent country, however, if some of those services exports are achieved by commercial presence in that country (as with the United States in wholesale banana markets within the EC – see WTO, 1999a). For the sake of equivalence, comparable points in the marketing chain also should be used for measuring the trade flow to be prohibited on the retaliation side.

The limitations on cross-retaliation

Another feature of economic and political significance in the retaliation procedures has to do with DSU Article 22.3. That Article states that the complainant should retaliate in the same sector wherever practicable. For example, retaliation against a goods violation should be in goods. In the case of retaliation against a services or TRIPs violation, however, DSU Article 22.3(f) is even more precise. There are 11 services categories and nine TRIPs categories separately identified, and the retaliation should where practicable match the services or TRIPs category of the violation. Where there are multiple violations in more than one category, the retaliation is expected to be in the same categories in similar proportion.

From an economic viewpoint this raises two puzzles. First, why are services or TRIPs so finely subdivided when their trade importance is so much less than goods, which are treated as a single category? And, second, why not allow the possibility of cross retaliation so as to maximize the opportunity to encourage policy reform by the respondent, and to minimize the limitation that within-sector retaliation poses where the economies of the two parties are vastly different in size?

While there are strict conditions attached to cross retaliation, that possibility is not completely ruled out. The conditions under which it is allowed are laid out in DSU Article 22.3. And already it has been used: in the case of the EC banana import regime, it was recognized by the Arbitrator that Ecuador imported too few goods from the EC to be able to retaliate in just goods, or even goods plus services, and so a suspension of concessions relating to TRIPs was allowed¹¹ (WTO, 2000).

4. Implications of globalization for trade dispute settlement

Globalization includes the phenomenon of economic integration resulting from the fall in transactions costs of doing business across space, including across national borders. The fall in barriers to trade in goods, services, financial capital and ideas has been a consequence of declining transport and communications costs, most recently because of the digital revolution, as well as trade and other regulatory reforms (see WTO, 1998; World Bank, 1999). One consequence is that services and ideas are growing in relative importance in the world economy and in global trade (see World Bank, 1998).

This phenomenon is making the measurement of trade damage and hence equivalent trade retaliation more complicated for the WTO compared with its

¹¹ Mavroidis (2000, p. 804) points out that it is not clear from DSU Article 22.3 whether the Arbitrator needed to be so intrusive or whether it could have been left it to the complainant to decide where to suspend concessions.

GATT predecessor when only goods were of significance. Even discerning a nation's economic interest in a dispute can become difficult now that services and TRIPs are involved. For example, a country may have its services exports curtailed by another country's WTO-inconsistent policy measure in a way that restricts a third country's exports of goods to which those services are added, in which case the f.o.b. export price and volume of that good fall.

A further complication arises if a country is an importer of a good, but a supplier of services to the export of that good to third countries. As was true for the United States in the EC banana import case, US economic welfare has been enhanced by the lower international price of Latin American bananas, even though EC policies have reduced US banana services exports that might have been attached to Latin American banana sales to the EC.

Two other aspects of the spread of globalization also are relevant. One is the growth of multinational corporations (MNCs); the other is the related disaggregation of production into ever-more footloose intermediate production processes.

WTO trade dispute settlement procedures cause a problem for MNCs to the extent that the share of their production outside their home country dominates, and the number of countries in which they produce a particular product grows. This stems from the WTO convention that a product is considered to be exported solely from the country of final transformation, as defined by the World Customs Organization's classification. If the export-oriented production of an MNC is outside its home country, then the host country's government needs to defend it in the WTO. If there are many such host countries, there is likely to be less interest taken by any one of them.¹²

Globalization and the growth of MNCs also are generating an ever-finer fragmentation of production processes that seek out the ever-changing lowest cost locations globally. A growing share of the intermediate inputs and value added by those plants is sourced from abroad (Feenstra, 1998). Hence even if a product undergoes sufficient transformation to alter its customs classification, the vast majority of its value could be due to the productive activities of another country. The convention that the host country has 100 per cent of the right to retaliate against another country's WTO-inconsistent policy while the input-supplying country has no right to retaliate is looking increasingly inappropriate as this aspect of globalization proceeds.

5. Scope for reforming the DSU

The most obvious implication to come out of WTO arbitration so far is the need to tighten current procedural rules in Articles 21.5 and 22 of the DSU. The problem is

¹² In principle, there is also the possibility that the interests of a MNC from a non-WTO member country could be defended by a host country that is a WTO member. In practice, however, this is becoming less and less relevant as the WTO membership expands: as of early 2002, all but 5 per cent of global trade emanates from WTO members.

now well recognized and alternative procedures are under consideration. Even with those sequencing uncertainties removed, however, it is unlikely that compensation will be preferred to the economically less-efficient temporary measure of retaliation to entice a respondent to bring its trade regime into line with WTO obligations, for the political economy reasons mentioned in section 2.

The economic purist might wonder why the value of imports curtailed, rather than a valuation of the national economic welfare consequences of the import barriers, is used to determine equivalence in retaliation to nullification or impairment. The reason probably has much less to do with an understanding of economics than with the relative simplicity of the traditional concept of trade equivalence.

Meanwhile, the ethicist might wonder why the present peculiar concept of equivalence is adhered to during the dispute settlement period. One reason to question it is that a greater dose of retaliation could speed up the process of becoming compliant – the apparent objective of the drafters of the DSU.¹³

A second equity concern is that retaliation does not help the complainant's exporters who have been and continue to be harmed, nor are the respondent's industries harmed by the retaliation the same ones that have been helped by the WTO-inconsistent measure. Monetary compensation to the complainant from the respondent may offer more scope for governments to target the transfers to achieve a more-equitable outcome (and in the process to capture at least the full historical cost of the WTO-inconsistent measure to the complainant, if not also to add a punitive element).

A third equity concern is that small complainants are not as able as large ones to inflict damage on large respondents. For that reason Horn and Mavroidis (1999, page 22) suggest consideration be given to the notion that the rest of the WTO membership contribute to the cost of small countries taking retaliatory action, so as to reduce the risk of large traders remaining WTO inconsistent. This is part of the bigger issue of technical and financial assistance for developing countries to participate in the DSU more broadly, and indeed in all of the WTO's activities.

Finally, with the ever-widening spread of multinational corporations and the ever-greater fragmentation of production as globalization proceeds, national governments are gradually becoming less appropriate bodies to defend the interests of multinational corporations. Will the day come when firms will be allowed to defend their trade interests directly at the WTO? Meanwhile, such firms are likely to come under increasing pressure to supplement the taxpayers' money needed to cover the complainant's cost of dispute settlement activities that involve their pecuniary interests – especially if, as was possibly the case in the US complaint against the EC banana regime (Bhala, 2000, pp. 968–970), national welfare in the complainant's

¹³ Note that the Panel considering the EC banana import regime case could not find anything in Article 22 of the DSU to justify punitive retaliation (WTO, 1999a). But note also that the International Law Commission's Draft of 16 July 1996 on State Responsibility does not consider compensation for damage already incurred from an illegal activity as punitive (Horn and Mavroidis, 1999, p. 5).

economy may have been boosted rather than harmed by the WTO-inconsistent measure.

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