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# Trade, Law *and* Development

Vol. 3, No. 2

2011

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The Registrar, National Law University, Jodhpur

ISSN : 0976-2329 | eISSN : 0975-3346

Claus D. Zimmermann, *Toleration of Temporary Non-Compliance: The Systemic Safety Valve of WTO Dispute Settlement Revisited*  
3(2) TRADE L. & DEV. 382 (2011)

TOLERATION OF TEMPORARY NON-COMPLIANCE:  
THE SYSTEMIC SAFETY VALVE OF WTO DISPUTE  
SETTLEMENT REVISITED

CLAUS D. ZIMMERMANN\*

*Ever since the World Trade Organization (WTO) came into being, there has been much academic debate as to whether efficient breach of WTO rules is, or should be, encouraged under the provisions governing WTO dispute settlement. This article argues that, although the WTO's dispute settlement mechanism has not been designed to encourage efficient breach, the existing system accommodates, de facto, temporary non-compliance. By operating at least temporarily as a system of 'breach and pay', the current design of the WTO's dispute settlement mechanism fulfils a crucial role as a systemic safety valve for rare scenarios where WTO Members find it impossible to comply with the DSB's recommendations and rulings within the 'reasonable period of time' as determined according to Article 21.3 of the DSU. This article takes a fresh look at the underlying nature of entitlements under WTO law and their respective protection before proceeding to a review of the existing avenues for both intra- and extra-contractual flexibility under the WTO legal framework. It also explains why economic efficiency should properly be viewed as being a merely subsidiary factor under the current design of the WTO's dispute settlement mechanism and elaborates what this implies. This review supports the conclusion that the WTO legal framework provides WTO Members with a balanced compromise between legal security and flexibility, with reputational concerns acting as the key incentive towards compliance. It is this compromise between legal security and flexibility which ensures that sovereign states remain willing to give up large parts of their freedom of action in trade matters by adhering to the WTO in the first place, and participate in future rounds of trade liberalization. In light of the analysis provided in this article, any calls for equipping the WTO's dispute settlement mechanism with tougher sanctions appear misguided.*

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*‘[M]odels can be mistaken for the total view of phenomena, like legal relationships, which are too complex to be painted in any one picture.’<sup>1</sup>*

-Guido Calabresi & A. Douglas Melamed

## I. INTRODUCTION—THE DEBATE ON EFFICIENT BREACH OF WTO RULES

According to the economic theory of contract,<sup>2</sup> it is not efficient for the parties to very complex agreements ‘to specify in advance how they ought to behave under every conceivable contingency’.<sup>3</sup> Circumstances may arise in which it is in the parties’ joint interest to facilitate the ‘efficient breach’ of the bargain.<sup>4</sup> According to this logic, enforcement systems ought to be designed in a way that ‘induce[s] a party to comply with its obligations whenever compliance will yield greater benefits to the promisee than costs to the promisor, while allowing the promisor to depart from its obligations whenever the costs of compliance to the promisor exceed the benefits to the promisee’.<sup>5</sup> In other words, economically

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<sup>1</sup> Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1128 (1972) (hereinafter Calabresi & Melamed).

<sup>2</sup> For detailed explanations on the economic theory of contract (also commonly referred to as private contract theory by common-law doctrine), originally developed by the law and economics movement in the United States, see, for example, ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 195-244 (Pearson Education, 5<sup>th</sup> ed. 2007) (hereinafter COOTER & ULEN).

<sup>3</sup> Warren Schwartz & Alan O. Sykes, *The Economic Structure of Renegotiation and Dispute Resolution in the World Trade Organization*, 31 J. LEGAL STUD. 179, 181 (2002) (hereinafter Schwartz & Sykes).

<sup>4</sup> See generally, COOTER & ULEN, *supra* note 2, at 262-66.

<sup>5</sup> Schwartz & Sykes, *supra* note 3 at 181.

efficient breaches should be encouraged; only inefficient ones should be deterred.<sup>6</sup>

Since the World Trade Organization (WTO) came into existence in 1995, there has been much academic debate about the extent to which efficient breach of WTO rules is encouraged under the Dispute Settlement Understanding (DSU).<sup>7</sup> This debate is grounded in the widespread recognition that there are significant conceptual parallels between incomplete private contracts and international trade agreements. Like private contracts, international trade agreements are incomplete in the sense that they do not specify in advance how the treaty parties ought to behave in every thinkable future scenario, as providing such specification would have been either impossible, or by far too complex and costly. Schwartz and Sykes, for example, approaching the issue from the viewpoint of public choice theory, succinctly describe these parallels as follows:

[T]he parties to trade agreements, like the parties to private contracts, enter the bargain under conditions of uncertainty. Economic conditions may change, the strength of interest group organization may change, and so on. Accordingly, officials cannot be certain that the bargain they strike will benefit them in all of its details. Likewise, even where the bargain on a particular issue is initially beneficial, changing circumstances may make it politically unappealing. For these reasons, the drafters of trade agreements may be expected to include devices for adjusting the bargain when it proves mutually disadvantageous.<sup>8</sup>

These parallels convincingly explain why the WTO agreements contain explicit provisions enabling WTO members to deviate from their obligations in an intra-contractual manner, i.e. in a way that provides them with a certain amount of flexibility without amounting, strictly speaking, to a breach of obligation that would impair the existing balance of mutual concessions among WTO members.<sup>9</sup> The escape clause in Article XIX of the General Agreement on Tariffs and Trade 1994,<sup>10</sup> which already existed under the former GATT, the Agreement on

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<sup>6</sup> See, for example, Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284-86 (1970) (hereinafter Birmingham).

<sup>7</sup> Art. 1, Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401 (hereinafter DSU). The WTO Legal Texts are available at: [http://www.wto.org/english/docs\\_e/legal\\_e/legal\\_e.htm](http://www.wto.org/english/docs_e/legal_e/legal_e.htm).

<sup>8</sup> Schwartz & Sykes, *supra* note 3 at 184.

<sup>9</sup> By contrast, the term 'extra-contractual flexibility' refers to the extent to which it is possible to breach valid treaty obligations and to remain in non-compliance. For a detailed explanation, see Part III of this article.

<sup>10</sup> General Agreement on Tariffs and Trade 1994, Apr. 15, 1994, Marrakesh

Safeguards,<sup>11</sup> as well as the detailed provisions for modifying tariff schedules via renegotiation in Article XXVIII of the GATT 1994 and for modifying scheduled services commitments in Article XXI of the General Agreement on Trade in Services (GATS)<sup>12</sup> accommodate such intra-contractual flexibility. However, as explained below, the existing literature remains divided on the question of to what extent efficient breach via extra-contractual flexibility is accommodated, or should be accommodated, under the rules of WTO dispute settlement.

In order to gain a rough idea of the potential practical relevance of the debate on efficient breach in a WTO context, it appears helpful to take a look at the approximate dimensions of the phenomenon of long-term non-compliance with WTO rules. It seems safe to say that most instances of long-term non-compliance arise from deliberate treaty violations and are therefore distinct from good-faith breaches of the WTO's highly complex legal framework. In the period between the WTO's inception in 1995 and November 1, 2011, there have been 423 requests for consultations, with panels having been established in 234 cases and with panel reports having been adopted in 154 of those cases. However, only a small proportion of these 154 disputes—less than 4.5 per cent of all initial requests for consultations<sup>13</sup>—were litigated through to the eventual authorization of trade retaliation. A mere 19 arbitration awards (covering 12 different disputes) on the level of suspension of concessions have been issued under Article 22.6 of the DSU so far.<sup>14</sup> Overall, long-term non-compliance appears to be a rare phenomenon at the WTO.<sup>15</sup>

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Agreement Establishing the World Trade Organization, Annex 2, 1867 U.N.T.S. 187 (hereinafter GATT 1994).

<sup>11</sup> Agreement on Safeguards, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A (hereinafter Safeguards Agreement).

<sup>12</sup> General Agreement on Trade in Services, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B (hereinafter GATS).

<sup>13</sup> This figure is necessarily somewhat biased by the fact that a significant proportion of WTO disputes has not yet had a chance to reach the implementation/enforcement stage. Assuming that several of the more recently initiated disputes might lead up to arbitration awards under DSU Article 22.6, the actual percentage may indeed be slightly higher than the above-mentioned 4.5 per cent.

<sup>14</sup> For the current status of WTO disputes, see [http://www.wto.org/english/tratop\\_e/dispu\\_e/dispu\\_current\\_status\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/dispu_current_status_e.htm).

<sup>15</sup> For a better understanding of the analysis provided in this article it appears useful to briefly summarize the most important features of WTO dispute settlement as framed by the rules and procedures set forth in the DSU. Once a non-appealed panel report or a report by the Appellate Body has been adopted by the WTO Dispute Settlement Body (hereinafter DSB), the WTO Member whose measures have been found to violate WTO law will have to clearly indicate whether and how it intends to comply with the DSB's recommendations and rulings (DSU, Article 21.3). If it is impracticable to comply immediately, the respondent will be given 'a reasonable period of time' in order to make

With the notable exception of Schwartz and Sykes,<sup>16</sup> the existing literature does not call into question Jackson's detailed analysis,<sup>17</sup> which concludes that, from a purely legal point of view, WTO rules as interpreted in WTO dispute settlement reports constitute firmly binding legal obligations. Deriving from this, even with compensation or trade retaliation in place, as succinctly put by Mavroidis, 'the WTO member author of the illegal act continues the illegality and has not fulfilled

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the necessary legislative or regulatory changes. This 'reasonable period of time' will be determined either by mutual agreement between the parties and approval by the DSB or through binding arbitration (DSU, Article 21.3). In any event, the DSB will keep the implementation under regular surveillance until the issue is resolved (DSU, Article 21.6). If the inconsistent measure is not withdrawn within the 'reasonable period of time', the claimant and the respondent must negotiate over compensation (DSU, Article 22.2). Although the DSU does not forbid that such compensation be pecuniary in nature, compensation usually takes the form of an equivalent lifting of trade barriers by the losing party. It is only if these negotiations fail, that the claimant may request authorization from the DSB to suspend concessions or other obligations, in other words, to proceed to trade retaliation against the respondent and raise trade barriers not exceeding the level of nullification or impairment caused by the breach at issue (DSU, Article 22.4). In principle, concessions should be suspended in the same sector as that which is at issue in the dispute at hand (DSU, Article 22.3(a)). If this is not practicable or effective, the suspension can be made in a different sector of the same agreement (DSU, Article 22.3(b)). In turn, if this is not effective or practicable and if the circumstances are serious enough, the suspension of concessions may be made under another WTO agreement (DSU, Article 22.3(c)). The last scenario is usually referred to as cross-retaliation, although officially, neither the terms 'retaliation' nor 'sanctions' are used in the DSU. Disagreements over the proposed level of suspension may once again be referred to binding arbitration (DSU, Article 22.6). The DSU does not provide for retroactive compensation for the economic harm a Member suffered from a WTO-inconsistent measure, i.e. for reparation of past damages. Under the system as it currently exists, compensation and the suspension of concessions merely provide some sort of rebalancing of mutually effective trade concessions in case a Member is still found in non-compliance after the above-mentioned 'reasonable period of time' has expired. The DSU clearly states that both compensation and the suspension of concessions are only temporary measures with compliance remaining the ultimate goal of WTO dispute settlement. For a detailed presentation and analysis of the rules and procedures contained in the DSU, see, for example, WTO SECRETARIAT, A HANDBOOK ON THE WTO DISPUTE SETTLEMENT SYSTEM (WTO & Cambridge Univ. Press 2004), and PETER VAN DEN BOSSCHE, THE LAW AND POLICY OF THE WORLD TRADE ORGANIZATION 269-307 (Cambridge Univ. Press 2ded., 2008) (hereinafter VAN DEN BOSSCHE).

<sup>16</sup> Schwartz & Sykes, *supra* note 3 at 189-92.

<sup>17</sup> John H. Jackson, *The WTO Dispute Settlement Understanding—Misunderstandings on the Nature of Legal Obligation*, 91 AM. J. INT'L L. 60 (1997) (hereinafter Jackson-Misunderstandings); John H. Jackson, *International Law Status of WTO Dispute Settlement Reports: Obligation to Comply or Option to "Buy Out"?*, 98 AM. J. INT'L L. 109 (2004) (hereinafter Jackson-Obligation).

its international obligations'.<sup>18</sup> However, in line with Trachtman's realistic observation that WTO law 'does not normatively demand compliance at all costs',<sup>19</sup> the well-established view holds that the WTO's dispute settlement mechanism functions *de facto*, though not in a strictly legal sense, as a system of 'breach and pay'.<sup>20</sup> As long as a WTO Member is willing and able, either to compensate other Members affected by its treaty violation, or to endure trade retaliation—whose amount is determined by binding arbitration—the existing mechanism does indeed enable WTO Members to temporarily deviate from some of their obligations under WTO law. However, as noted above, this does not lead to the disappearance of the formal obligation to fully comply at some point in the future.

Based on this realistic view of the WTO's dispute settlement mechanism as a system of (at least temporary) 'breach and pay', several authors have analysed, first, whether the dispute settlement mechanism in its current shape encourages efficient breach. Second, if not, how could it be modified in order to achieve the theoretical ideal of efficient breach, assuming this constitutes a desirable objective for WTO dispute settlement. Pelc, for example, has argued generally against the efficiency of breach of international trade agreements by focussing on the huge transactions costs generated by compensation and trade retaliation.<sup>21</sup> Collins has proposed ways to address the dual inefficiency of 'damages' calculation in WTO dispute settlement – arising from the absence of retroactive damages and the imprecision of damages assessment – in order for the system to encourage only breach that is truly efficient.<sup>22</sup> An important clarification has been provided by Trachtman who has rightly pointed out that analysing WTO dispute settlement from the viewpoint of public choice theory as a system that encourages politically efficient breach (as

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<sup>18</sup> Petros Mavroidis, *Remedies in the WTO Legal System: Between a Rock and a Hard Place*, 11 EUR. J. INT'L L. 763, 800 (2000).

<sup>19</sup> Joel P. Trachtman, *The WTO Cathedral*, 43 STAN. J. INT'L L. 127, 130 (2007) (hereinafter Trachtman). It should be noted that Trachtman's observation flows directly from the fact that, according to Article 22.4 of the DSU, the level of trade retaliation authorized by the DSB shall be equivalent to the level of nullification or impairment resulting from the breach at issue. The DSU provides neither for the imposition of punitive damages nor for an increase beyond the just mentioned equivalence level of trade retaliation in the case of persisting non-compliance.

<sup>20</sup> See, for example, Judith Bello, *The WTO Dispute Settlement Understanding: Less is More*, 90 AM. J. INT'L L. 416 (1996) (hereinafter Bello); B. Peter Rosendorff, *Stability and Rigidity: Politics and Design of the WTO's Dispute Settlement Procedure*, 99 AM. POL. SCIENCE REV. 389 (2005); Trachtman, *supra* note 19.

<sup>21</sup> Krzysztof J. Pelc, *Seeking Escape: The Use of Escape Clauses in International Trade Agreements*, 53 INT'L STUD. Q. 349 (2009) (hereinafter Pelc).

<sup>22</sup> David Collins, *Efficient Breach, Reliance and Contract Remedies at the WTO*, 43 J. WORLD TRADE 225 (2009) (hereinafter Collins).

done notably by Schwartz and Sykes<sup>23</sup>) tells us little on how to change the current system in order to maximize general public welfare.<sup>24</sup>

Finally, in an interesting, recent contribution, Pelc has explained the choice of the drafters of the WTO Agreement to not formally authorize WTO members to 'buy out' of their obligation to comply, with arguments drawn from domestic politics.<sup>25</sup> As explained convincingly by Pelc, signalling to domestic interest groups and voters that breach of WTO rules is a realistic policy option would run counter to the very reasons for which states enter into free trade agreements in the first place. However, in light of the fact that the DSU under its current design clearly signals that 'breach and pay' is at least a temporary option, such arguments drawn from domestic politics fail to explain why we do not see more instances of long-term non-compliance at the WTO. Other factors such as reputational concerns and a silent consensus among WTO members to deviate from the existing bargain only under exceptional political constraints might indeed be more important reasons for why we see so little long-term non-compliance at the WTO.<sup>26</sup>

Whereas all of the aforementioned works and others addressed throughout this article provide valuable insights into various aspects of the economic incentives that play a role in WTO dispute settlement, they fail to provide sufficiently convincing conclusions on the issue of efficient breach in the WTO context. This is due to the fact that these works are built either on the rigid assumption that the existing system is designed to encourage efficient breach but needs to be reformed in order to overcome existing problems such as imprecise damages assessment, or on the equally rigid assumption that strict compliance at any time is the system's key objective and that the scope for extra-contractual flexibility, whether efficient or not, should therefore be reduced to zero.

This article argues that neither of these positions appropriately characterizes the key features of WTO dispute settlement. The WTO's dispute settlement mechanism has clearly not been designed to facilitate efficient breach, but is flexible enough to accommodate temporary non-compliance in rare scenarios where compliance within the 'reasonable period of time' as set by the DSB is

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<sup>23</sup> Schwartz & Sykes, *supra* note 3.

<sup>24</sup> Trachtman, *supra* note 19. Trachtman's criticism seems fully justified in light of the fact that whereas public choice theory is a useful economic tool to study the behaviour and the decisions of government officials as mostly self-interested agents seeking to maximizing their political welfare, taking mostly the form of campaign contributions and votes, its narrow analytical approach deliberately ignores many factors that affect general public welfare.

<sup>25</sup> Krzysztof J. Pelc, *Eluding Efficiency: Why do we not see more efficient breach at the WTO?*, 9 *WORLD TRADE REV.* 629 (2010).

<sup>26</sup> On this point *see, for example*, Schwartz & Sykes, *supra* note 3 at 194-99.

impracticable for a WTO member facing exceptionally fierce domestic resistance. The current design of the WTO's dispute settlement mechanism, by *de facto* accommodating at least temporary 'breach and pay', functions as a systemic safety valve. As shall be argued in this article, a certain amount of extra-contractual flexibility as provided under the DSU in its current shape fulfils a highly valuable function in ensuring that WTO members remain willing to participate in future rounds of increasing trade liberalization.

The remainder of this article proceeds as follows: Part II takes a fresh look at the underlying nature of entitlements under WTO law and their respective protection. Part III elaborates on the importance of distinguishing intra-contractual from extra-contractual flexibility as accommodated under the WTO legal framework. Part IV explains why economic efficiency should be properly viewed as being a merely subsidiary factor under the current design of the WTO's dispute settlement mechanism and elaborates what this implies. Part V examines the *de facto* toleration of temporary non-compliance under the DSU, and its function as an important systemic safety valve. Part VI concludes.

## II. THE UNDERLYING NATURE OF ENTITLEMENTS UNDER WTO LAW AND THEIR RESPECTIVE PROTECTION REVISITED

According to private contract theory, the precise way in which the objective of encouraging efficient, and discouraging inefficient, breach is to be achieved, i.e. the way in which the relevant enforcement mechanism is to be designed, depends crucially on the nature of the underlying legal rule and its protection. As elaborated by Calabresi and Melamed in their seminal concept of entitlements, rights that are established and protected by law can be qualified as either entitlements protected by a property rule, as entitlements protected by a liability rule, or as inalienable entitlements.<sup>27</sup> An entitlement protected by a property rule cannot be taken from its holder unless the latter is willing to sell it, at a price which reflects how he subjectively values the property. For entitlements protected by a liability rule, an external, objective standard of value is used in order to determine how much the destroyer of an entitlement will have to pay to its original holder. Finally, for inalienable entitlements the sale of property is not permitted, even between a willing buyer and a willing seller.<sup>28</sup>

Concerning the choice of the right type of entitlement protection, the conventional wisdom in the law and economics literature held for a long time that allocation by the market is generally cheaper than allocation by the law whenever

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<sup>27</sup> Calabresi & Melamed, *supra* note 1, at 1105-15.

<sup>28</sup> In the international realm, the prohibition of genocide would be an outstanding example of an inalienable entitlement.

transaction costs are low. In other words, where transaction costs are high, it was said to be inefficient to protect a legal entitlement by a property rule; a liability rule should be used instead. This view was broadly adhered to in academic writing for many years,<sup>29</sup> despite the fact that Polinsky had shown early on that transaction costs were not the only impediment to bargaining, but that the costs linked to damages assessment introduced significant additional bias.<sup>30</sup> Measurement of damages by a court is almost always costly. In addition, damages assessment is rarely an exact science. This is highly problematic because if damages are too low they will encourage inefficient breach, while if they are too high they will deter it.<sup>31</sup> Krier and Schwab have provided a convincing explanation for why the view that whenever transaction costs are high liability rules should be used instead of property rules has persisted for so long in the literature:

The error in this conventional view arises because conventional thinking ignores uncertainty about damages (due to assessment costs) at the same time that it realistically acknowledges bargaining difficulties (due to transaction costs). Once we recognize that in the real world both transaction costs *and* assessment costs are regularly significant, the bald preference for liability rules loses its foundation.<sup>32</sup>

The parties to an incomplete private contract wishing to avoid inefficient, and encourage efficient, breach are thus generally left with the following options. In the case of entitlements protected by a property rule, and in the presence of low transaction costs, the party wishing to deviate from the rule can always renegotiate the allocation of a given entitlement with the other party concerned in order to determine whether there is any scope for efficient breach. According to the theory of efficient breach, the party interested in breaching a specific obligation should be able to obtain permission from the other party to do so by paying a pecuniary compensation if the value of the breach exceeds the value of performance of the obligation to the other party. By contrast, if the harm arising from the breach exceeds its value, there will be a clear incentive for efficient performance.

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<sup>29</sup> For a detailed discussion, see James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. REV. 440, 452-5 (1995) (hereinafter Krier & Schwab).

<sup>30</sup> A. Mitchell Polinsky, *Controlling Externalities and Protecting Entitlements: Property Right, Liability Rule, and Tax-Subsidy Approaches*, 8 J. LEGAL STUD. 1 (1979); A. Mitchell Polinsky, *On the choice between Property Rules and Liability Rules* 18 ECON. INQUIRY 233 (1980); A. Mitchell Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075 (1980).

<sup>31</sup> See Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 6-7 (1989); Schwartz & Sykes, *supra* note 3, at 182.

<sup>32</sup> Krier & Schwab, *supra* note 29 at 454 (footnote omitted; original emphasis).

Renegotiation of an entitlement between the parties can take place either before any breach has occurred (renegotiation *ex ante*) or after a court order for specific performance (renegotiation *ex post*).<sup>33</sup> The doctrine of efficient breach requires that any violation of an order for specific performance be punished so severely that the party concerned will always prefer to perform unless it can successfully renegotiate the existing property rule with the other party.<sup>34</sup>

For entitlements protected by a liability rule, the common law of contract disposes of three alternative damage measures that correspond to three different interests of the injured party: restitution,<sup>35</sup> reliance,<sup>36</sup> and expectation.<sup>37</sup> Expectation damages are the remedy commonly associated with the theory of efficient breach. A party that knows that it will have to repay any future profits lost by another party as a consequence of the breach will breach the contract only if it gains more from the breach than the other party loses.<sup>38</sup> In practice, however, as elaborated in detail by Collins, the estimation of lost future profits arising from non-performance can be a highly complicated task.<sup>39</sup> The costs arising from litigation and damages assessment by the court further blur the picture. Overall, if the damages that have to be paid fall short of the real total cost arising from the breach, the breach that is encouraged will be inefficient. However, if the damages are set at too high a level, they will deter breach that would otherwise have been efficient.

It would obviously be unrealistic to expect that the characteristics of international trade law fit perfectly into the legal categories established by the common law of contract. Hence, one should keep in mind that any analogy will necessarily be only approximate in nature, despite the obvious parallels between both legal regimes as noted earlier.

In the existing literature, three different views have been brought forward.

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<sup>33</sup> See Schwartz & Sykes, *supra* note 3 at 182.

<sup>34</sup> See *id.*

<sup>35</sup> The restitutionary measure requires that any benefits, pecuniary or otherwise, which the injured party transferred to the breaching party between the formation of the contract and its breach, be returned.

<sup>36</sup> Under reliance damages, any costs which have arisen to the injured party because it relied on the performance of the contract can be recovered as reliance loss.

<sup>37</sup> The objective of expectation damages is to put the injured party into as good a position as it would have been in, had the contract been properly performed.

<sup>38</sup> For detail on this point, see, for example, John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277, 283-89 (1972); Birmingham, *supra* note 6, at 284-86; and Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980).

<sup>39</sup> Collins, *supra* note 22, at 230-32.

Schwartz and Sykes<sup>40</sup> argue that, both as a matter of law and fact, entitlements under WTO law are protected by a liability rule, not only with respect to the renegotiation and unilateral modification of tariff and services schedules, but also under the rules of the DSU where WTO members may *de facto* choose to either provide compensation or endure trade retaliation indefinitely, instead of rectifying an existing breach of obligation.

Trachtman,<sup>41</sup> by contrast, accepts the thorough analyses provided by Jackson,<sup>42</sup> Nzelibe,<sup>43</sup> Pauwelyn<sup>44</sup> and others that WTO law is mandatory law with compensation or trade retaliation being merely temporary solutions (the temporary character of these measures being explicitly enshrined in the first sentence of Article 22.1 of the DSU) which do not seal a final shift of entitlements. Trachtman suggests that one needs to carefully distinguish between the law as legislated and the law in action and concludes that 'as a matter of fact and practice, if not as a matter of legal doctrine, the WTO legal system is best characterized as employing a liability rule, rather than a property rule'.<sup>45</sup>

As shown by Pauwelyn however,<sup>46</sup> it is rather the rule than the exception that property rules in the international realm are protected by rather weak back-up enforcement as exemplified, notably, by the limited possibilities for compensation and proportional countermeasures under the DSU. Pauwelyn recalls that this state of affairs is due to: first, the consensual nature of international law and the desire for flexibility shared by the states which are parties to highly complex and necessarily incomplete contracts; second, the lack of centralized control over breach; and third, power imbalances between states.<sup>47</sup> He argues convincingly that in the international realm mere compensation and proportional countermeasures will often be sufficient as back-up enforcement for a property rule. With respect to WTO dispute settlement, for example, he suggests that 'community costs', such as concerns related to reputation and emulation by other countries, will add to the formal sanctions available and will therefore raise the cost of non-compliance in a manner that will (at least in most disputes) create sufficient incentive to comply

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<sup>40</sup> Schwartz & Sykes, *supra* note 3.

<sup>41</sup> Trachtman, *supra* note 19.

<sup>42</sup> Jackson—*Misunderstandings* & Jackson—*Obligation*, *supra* note 17.

<sup>43</sup> Jide Nzelibe, *The Credibility Imperative: The Political Dynamics of Retaliation in the World Trade Organization's Dispute Resolution Mechanism*, 6 THEORETICAL INQUIRIES IN L. 215 (2005).

<sup>44</sup> Joost Pauwelyn, *Enforcement and Countermeasures in the WTO: Rules are Rules—Toward a More Collective Approach*, 94 AM. J. INT'L L. 335 (2000) (hereinafter Pauwelyn).

<sup>45</sup> Trachtman, *supra* note 19, at 146.

<sup>46</sup> JOOST PAUWELYN, OPTIMAL PROTECTION OF INTERNATIONAL LAW (Cambridge Univ. Press 2008) (hereinafter PAUWELYN).

<sup>47</sup> *Id.* at 157-63.

with dispute settlement reports, despite the seemingly weak back-up enforcement of the latter.<sup>48</sup>

As noted earlier, the DSU provides WTO Members with a certain amount of extra-contractual flexibility by ensuring that the level of compensation, or of proportional countermeasures as authorized by the DSB does not exceed the level of the nullification or impairment arising from the measure(s) found to breach WTO law.<sup>49</sup> In addition, as previously noted, the DSU ensures that if the party found to be in breach objects to the level of trade retaliation set by the injured party, the issue will be decided by binding arbitration.<sup>50</sup> Hence, WTO Members are *de facto* in a position where they can ‘buy’ additional time whenever it is impossible for the member found to be in breach to comply immediately with the DSB’s findings. From a formal perspective, one could certainly argue that nothing in the WTO agreements prevents WTO Members from opting to be retaliated against indefinitely instead of establishing compliance,<sup>51</sup> which explains why parts of the literature have argued that WTO dispute settlement reports are *de facto* protected by a mere liability rule. For the following reasons, however, this view has to be refuted as being erroneous.

The analysis brought forward by Pauwelyn<sup>52</sup> (as summarized in its key aspects above) is the only one that convincingly reconciles economic reality with the widely accepted interpretation (provided by Jackson and others as noted above) of WTO law in general, and of dispute settlement reports adopted by the DSB in particular, as binding legal obligations from which no contracting out is possible.<sup>53</sup> As noted earlier, compensation and trade retaliation are merely temporary measures that do not seal a final shift of entitlements. Certainly, the DSU provides neither for punitive damages nor for the possibility that trade retaliation be gradually increased in excess of the amount of nullification or impairment in order to create a bigger incentive for the Member found in breach to establish compliance. However, as demonstrated by Pauwelyn, the seemingly weak back-up enforcement of WTO dispute settlement reports does not invalidate the conclusion that they are protected by a property rule.<sup>54</sup> As noted in the introduction, the overall compliance record of the WTO’s dispute settlement

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<sup>48</sup> *Id.* at 163-4.

<sup>49</sup> DSU, Article 22.4.

<sup>50</sup> DSU, Article 22.6.

<sup>51</sup> For detail on this point, see, for example, Yuka Fukunaga, *Securing Compliance Through the WTO Dispute Settlement System: Implementation of DSB Recommendations*, 9 J. INT’L ECON. L. 383, 396-98 (2006).

<sup>52</sup> PAUWELYN, *supra* note 46.

<sup>53</sup> But for the limited exception of renegotiation of tariff and services schedules as explained below.

<sup>54</sup> PAUWELYN, *supra* note 46 at 157.

mechanism is rather impressive. It therefore appears perfectly plausible to agree with Pauwelyn that ‘community costs’ such as reputational concerns, which have to be suffered by WTO Members found in breach of their obligations on top of the costs coming from compensation or proportional countermeasures, indeed act as a highly valuable ‘kicker’ towards compliance.<sup>55</sup> Most importantly, contrary to compensation and trade retaliation as authorized under the rules of the DSU, these ‘community costs’ can be expected to increase disproportionately with enduring non-compliance. The world trading system is built on the principle of increasing trade liberalization via a constantly on-going process of negotiations. In order to be able to obtain valuable concessions from other members in the future, WTO members have a major interest in being viewed as respecting the existing bargain and will endeavour to avoid long-term non-compliance.

Before moving on to the next section, the qualification of WTO dispute settlement reports as being protected by a property rule calls for a few additional comments in light of the definition of property rules as permitting a definitive shift of entitlements between a willing buyer and a willing seller. Article 3.5 of the DSU explicitly requires that ‘[a]ll solutions to matters formally raised under the consultation and dispute settlement provisions of the covered agreements, including arbitration awards, shall be consistent with those agreements and shall not nullify or impair benefits accruing to any Member under those agreements, nor impede the attainment of any objective of those agreements’. Pauwelyn has convincingly analysed this provision as not preventing the parties to a WTO dispute ‘from changing, adapting or dis-applying a particular rule as it applies to the dispute at hand *for as long as third-party rights remain unaffected*’.<sup>56</sup> Consistent with this view, so long as the rights and benefits enjoyed by other Members under WTO law are not negatively affected, the parties to a dispute may terminate their dispute on the basis of a mutually agreed solution in the sense of Article 3.6 of the DSU. This may indeed amount to a contracting out of existing WTO law as between the parties. As determined by Article 3.6 of the DSU, any such mutually agreed solution ‘shall be notified to the DSB and the relevant Councils and Committees, where any Member may raise any point relating thereto’, which helps to ensure that third-party rights remain unaffected. Distinctly different from the above is the situation where a Member found in breach is happy to endure trade retaliation indefinitely. Such a state of affairs would certainly not lead to a definitive shift of entitlements under the WTO law and would not lawfully terminate the dispute.<sup>57</sup>

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<sup>55</sup> *Id.* at 163-71.

<sup>56</sup> *Id.* at 109, note 6 (original emphasis).

<sup>57</sup> As demonstrated by Pauwelyn (Joost Pauwelyn, *A Typology of Multilateral Treaty Obligations: Are WTO Obligations Bilateral or Collective in Nature?*, 14 EUR. J. INT’L L. 907 (2003)), the debate on whether the parties to a WTO dispute may settle the dispute in deviation from the rules set forth in the WTO agreements hinges crucially on the question

As analysed in this section, the current design of WTO dispute settlement clearly provides WTO members *de facto* with a certain amount of extra-contractual flexibility. However, the possibility to deviate from WTO rules in general, and from dispute settlement reports in particular, which are appropriately analysed as being protected by a property rule, can provide only temporary relief to WTO members that find it impossible to establish compliance within the ‘reasonable period of time’ as set according to Article 21.3 of the DSU. Moving on to the next section, it is important to clearly distinguish this extra-contractual flexibility as accommodated under the rules of the DSU from intra-contractual flexibility under the WTO legal framework. Such intra-contractual flexibility refers to flexibility that is not built upon any sort of breach of the existing bargain, but that is part of that bargain and is, as such, a perfectly lawful option under WTO law.

### III. DISTINGUISHING INTRA FROM EXTRA-CONTRACTUAL FLEXIBILITY AS ACCOMMODATED UNDER THE WTO LEGAL FRAMEWORK

As noted in the introduction, the WTO agreements accommodate intra-contractual flexibility in two ways. First, via the escape clause in Article XIX of the GATT 1994, read and applied together with the detailed provisions in the Agreement on Safeguards. A WTO Member may apply a safeguard measure, i.e. restrict imports of a certain product temporarily, only if that member has determined, pursuant to the provisions in the Agreement on Safeguards, ‘that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products’.<sup>58</sup> Second, via the rules on modifying tariff schedules via

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of whether WTO rules are multilateral legal obligations of the bilateral type, i.e. a multilateral bundle of one-on-one legal relationships, or of the collective type, i.e. obligations that are owed by every member of the organization to all others collectively. Pauwelyn argues convincingly that most WTO rules should be considered as being of the bilateral type and that only some more recent WTO rules may be collective in nature (for example, many of those enshrined in the Agreement on the Application of Sanitary and Phytosanitary Measures (SPS Agreement) or the Agreement on Technical Barriers to Trade (TBT Agreement)), adding rightly that a detailed case-by-case analysis would have to be undertaken in a specific case. Other authors, notably Carmody (Chios Carmody, *WTO Obligations as Collective*, 17 EUR. J. INT’L L.419 (2006)), have refuted Pauwelyn’s analysis as erroneous and have suggested that the WTO legal framework be considered as a collective body of law, owed by every member to all others, individually and jointly. Although multilateral legal obligations of the bilateral and collective type are equally binding, distinguishing between the two has major implications under general international law for deciding who has standing in a dispute and for the manner in which to contract out of an international obligation.

<sup>58</sup> Agreement on Safeguards, Article 2.1. For detailed economic analyses of the GATT

renegotiation as set forth in GATT Article XXVIII and the rules for modifying scheduled services commitments in GATS Article XXI.

For the purposes of this article, as will be elaborated in further detail below, the second avenue is of particular interest. Whereas the WTO rules on safeguards essentially authorize a *temporary* and exceptional imposition of otherwise protectionist measures in order to enable ailing domestic industries to adjust to increased competition from abroad, the legal regime for modifying tariff and services schedules explicitly provides for an intra-contractual possibility to unilaterally modify the existing allocation of entitlements in the sense of a *permanent* shift of entitlements. Although any WTO Member wishing to withdraw a concession is obliged to negotiate with any other Member having a substantial interest in that concession so as to arrive at a mutually agreeable compensation, the withdrawing Member may go ahead and withdraw the relevant concession even if the negotiations over compensation break down. In such a case, adversely affected members merely have the right to withdraw substantially equivalent concessions or obligations.<sup>59</sup> They have no legal means to prevent the unilateral modification of schedules desired by the other member.

It should be stressed, as pointed out by Pauwelyn, that in the aforementioned case, the unilateral reintroduction of trade restrictions is explicitly permitted, and hence intra-contractual and not extra-contractual in nature.<sup>60</sup> As a consequence, when contemplating these avenues for intra-contractual flexibility in light of the doctrine of efficient breach, it is necessary to keep in mind that we are not confronted here with 'breach' in the sense of a treaty violation, but an explicitly authorized possibility to deviate unilaterally from the originally negotiated bargain. The precise way in which tariff concessions may be withdrawn following failed negotiations over their modification justifies, at the very least, a brief contemplation from the viewpoint of private contract theory.

The precise shape of the WTO rules regarding the renegotiation of tariff and services schedules demonstrates that not all entitlements under the WTO legal framework are protected by a property rule at all times, but that some of them may be taken from their holder at a price which might not reflect how he subjectively values it. With respect to renegotiation of scheduled tariff and services

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escape clause and the Agreement on Safeguards, *see, for example*, Alan O. Sykes, *Protectionism as "Safeguard": A Positive Analysis of the GATT "Escape Clause" with Normative Speculations*, 58 U. CHI. L. REV. 255 (1991); and Pelc, *supra* note 21.

<sup>59</sup> As determined by Article XXVIII:3 of GATT 1994. Under the corresponding provision in the GATS, unless mutual agreement can be reached, the level of 'substantially equivalent benefits' that may be modified or withdrawn by the affected Member will be determined by independent arbitration (GATS, Article XXI:3(a)-4(b)).

<sup>60</sup> PAUWELYN, *supra* note 46, at 137-38.

commitments, i.e. for any modification of individual concessions that occurs outside the scope of a formal dispute, it appears indeed appropriate to characterize WTO rules as being protected by a liability rule in accordance with the existing literature.<sup>61</sup> As recalled by Schwartz and Sykes ‘the magnitude of [that] “liability” is clearly specified—concessions substantially equivalent to those withdrawn by the Member that proceeds [to a modification of its tariffs or services schedule]’.<sup>62</sup> This perfectly corresponds to the essential characteristic of a liability rule as defined by Calabresi and Melamed: the use of an objective standard of value in order to determine how much the destroyer of an entitlement will have to pay to its original holder.<sup>63</sup>

The fact that WTO entitlements under the rules for renegotiation and modification of tariff and services schedules are being protected by a liability rule should obviously not be interpreted as confirming that under the existing rules on renegotiation, WTO Members are encouraged to proceed only to efficient shifts of entitlements. This depends crucially on the extent to which the assessment of the level of compensation or of the suspension of concessions properly reflects the loss that would arise for a WTO Member from the modification of another Member’s schedule. However, under the existing legal framework for renegotiation, no damages for past or future injury are required to be offered if a WTO member unilaterally reverts to an earlier, pre-negotiation tariff or pre-negotiation services schedule. The only recourse remaining for another WTO Member is to withdraw concessions substantially equivalent to those withdrawn earlier, which would result in additional harm to its own economy unless it is large enough for higher tariffs to lead to improved terms of trade.<sup>64</sup> Hence, the current legal framework for renegotiating tariff and services schedules, though protected under a liability rule, is far from providing expectation damages which would fully compensate affected WTO Members.<sup>65</sup> It therefore appears safe to say that by accommodating some amount of intra-contractual flexibility, WTO members were not seeking to encourage efficient deviations from the originally negotiated bargain. Instead, they appear to have aimed to establish a legal framework characterized by a certain degree of flexibility arising from the fact that once negotiated, tariff concessions are not cut into stone forever, but may be renegotiated under the above-noted provisions in both the GATT and the GATS, or may be temporarily disregarded in conformity with the Agreement on Safeguards. Such flexibility plays a crucial role in ensuring that WTO Members

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<sup>61</sup> See, for example, PAUWELYN, *supra* note 46, at 134-45; Schwartz & Sykes, *supra* note 3 at 183-88; and Trachtman, *supra* note 19 at 147-51.

<sup>62</sup> Schwartz & Sykes, *supra* note 3 at 187.

<sup>63</sup> Calabresi & Melamed, *supra* note 1 at 1105-6.

<sup>64</sup> See PAUWELYN, *supra* note 46 at 138.

<sup>65</sup> *Id.*

remain willing to make generous concessions in future rounds of trade liberalization, thereby clearly serving the systemic long-term interests of the international trading system.

The following section will demonstrate that this state of affairs, with efficiency not being the determinant factor in the existing system's design, is not limited to the renegotiation and unilateral modification of tariff and services schedules, but that the same is true for the WTO's dispute settlement mechanism with its *de facto* accommodation of temporary 'breach and pay'.

#### IV. EFFICIENCY AS A MERELY SUBSIDIARY FACTOR UNDER THE CURRENT DESIGN OF WTO DISPUTE SETTLEMENT

The manner of calculation of suspensions of concessions in the context of WTO dispute settlement possesses two essential characteristics which, if properly accounted for, clearly show that the existing system has not been designed to accommodate efficient breach. To begin with, the absence of retroactive 'damages' under the DSU necessarily implies that the WTO members affected by breach will never be fully compensated for all losses endured. Depending on the exact circumstances, these unrecoverable losses can reach impressive dimensions. The relevant dispute may have been pending before the competent panel for years with the protectionist measure continuing to cause its harmful effects. The time required for an appeal and various arbitrations under the rules of the DSU may have further increased the losses for which the negatively affected Member will never be granted any compensation. It follows that, in many cases, a WTO Member will be able to maintain a protectionist measure, and according to public choice theory, reap the related political benefits for many years without ever having to compensate for the loss which it inflicted on other Members. Under these circumstances, and putting aside for the moment other important factors such as reputational costs that potentially diminish the total value for the violator state of breaching WTO rules, it seems very likely that some WTO breaches are in fact not efficient at all.

The existing literature obviously does not ignore the above-described absence of retroactivity, but it fails to take it into account in an entirely convincing manner when applying the doctrine of efficient breach to WTO rules. Schwartz and Sykes, for example, approach the issue by arguing as follows:

[M]any (although not all) [WTO] disputes ... involve good-faith clashes over ambiguous terms of the bargain. In these circumstances, countries are often genuinely uncertain about what they are obliged to do, and sanctions may have the effect of punishing them for

good-faith behaviour. ... [T]here may be instances in which WTO provisions have been intentionally left vague ... A country found to be in violation of such obligations after the fact may thus have provided a public good by becoming the test case on a particular issue. The absence of sanctions for behaviour prior to an adverse ruling may thus be seen as a way to encourage nations to litigate their disputes to conclusion so as to clarify the rules for everyone.<sup>66</sup>

Certainly, claiming that many violations of WTO rules involve good-faith behaviour seems plausible. As demonstrated in detail by Schwartz and Sykes,<sup>67</sup> the domestic political cost of increased protectionism, reputational concerns, and the threat of unilateral sanctions contributed significantly to the high level of compliance witnessed throughout the GATT years, and nothing indicates that these mechanisms are no longer important reasons for the excellent compliance record of WTO dispute settlement today.<sup>68</sup> However, the fact that the founders of the WTO did not provide for the possibility of imposing retroactive 'damages' should be regarded as a choice driven not mainly by economic, but by political considerations as well. If one assumes that poor WTO Members, due to various capacity constraints, are more likely to commit a good-faith breach of the increasingly complex WTO legal framework, the absence of retroactive damages may indeed help to avoid aggravating existing disadvantages faced by poor Members participating in WTO dispute settlement. This point alone might already justify the absence of retroactive 'damages'. Additional economic considerations, such as the ones elaborated by Schwartz and Sykes as quoted in the preceding paragraph, further confirm this choice as a sensible one.

However, with respect to the efficiency or inefficiency of breach, it still remains that the absence of retroactive 'damages' completely blurs the picture of the overall balance of benefits and losses arising from a treaty violation. By deciding against retroactivity, thereby showing lenience with respect to good-faith breaches, the drafters of the WTO Agreement may have made a politically appropriate choice, which also procures some economic benefits like valuable clarification of ambiguous WTO rules via dispute settlement. At the same time however, good-faith breaches of WTO rules are no less harmful for the affected trading partner and its domestic industries than intentional, bad-faith, breaches.

Even if one were to entirely disregard the retroactivity issue for the sake of

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<sup>66</sup> Schwartz & Sykes, *supra* note 3, at 201.

<sup>67</sup> *Id.* at 194-200.

<sup>68</sup> The threat of unilateral sanctions goes obviously well beyond the scope of trade sanctions whose use is now strictly curtailed by WTO rules, and could potentially cover any issue of political and diplomatic importance between two states.

argument, to claim that ‘damages’ as set by WTO dispute settlement will enable WTO members to make efficient decisions on whether to breach a WTO rule seems highly problematic in light of the highly complex and necessarily quite approximate assessment of WTO ‘damages’. Certainly, Article 22.4 of the DSU states that ‘[t]he level of the suspension of concessions or other obligations authorized by the DSB shall be equivalent to the level of the nullification or impairment’. In addition, as previously noted, Article 22.6 of the DSU ensures that if the party found to be in breach objects to the level of ‘damages’ thus set by the injured party, the issue will be decided by binding arbitration. Schwartz and Sykes have interpreted this as one of the key innovations of the WTO Agreement arguing that:

[T]he reason for authorizing sanctions against recalcitrant violators in the new DSU is not to punish them so much as to protect them—instead of having to buy their way out in a world of unilateral threats and counter threats unconstrained by central oversight, the new system ensures that the price for noncompliance will be set in accordance with an honest and unbiased effort to assess the harm to the affected party (or parties).<sup>69</sup>

In subsequent work, however, Sykes has explicitly acknowledged that the analogy to expectation damages is imperfect, and that it fails in other respects such as ‘the question of how to measure and operationalise “equivalence”’ which, as he rightly notes, ‘is much less clear than in the private contract setting’.<sup>70</sup> Despite the expectation raised by the straightforward language employed in Article 22.4 of the DSU as quoted above, and contrary to the position taken by Schwartz and Sykes, it is well accepted in the literature that the actual level of WTO ‘damages’ as set by arbitration will, at best, come close to the level of ‘nullification or impairment’ caused by a given breach. This is mainly due to the difficulty faced by arbitrators in assessing the volumes of future trade foregone.<sup>71</sup> The fact that litigation costs are not included in this ‘damages’ assessment further distorts the economic incentives for WTO Members confronted with the decision of whether to comply with a specific WTO rule or not. In an attempt to respond to these assessment problems,

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<sup>69</sup> Schwartz & Sykes, *supra* note 3, at 203.

<sup>70</sup> Alan O. Sykes, *Optimal Sanctions in the WTO: The Case for Decoupling (and the Uneasy Case for the Status Quo)*, 379 STAN. L. & ECON. RES. PAPER SERIES 9-16 (2009).

<sup>71</sup> For detailed analyses of this point, *see, for example*, Kym Anderson, *Peculiarities of Retaliation in WTO Dispute Settlement*, 1 WORLD TRADE REV. 123, 129-30 (2002); Holger Spamann, *The Myth of “Rebalancing” Retaliation in WTO Dispute Settlement Practice*, 9 J. INT’L ECO. L. 31, 59 (2006); Jason Bernstein & David Skully, *Calculating Trade Damages in the Context of the World Trade Organization’s Dispute Settlement Process*, 25 REV. AGRIC. ECON. 385, 397 (2003). For a brief discussion of the main criticisms brought forward by the literature, *see* Collins, *supra* note 22, at 230-34.

Collins has suggested that WTO dispute settlement switch from the current expectation measure to a reliance measure when assessing the level of suspension of concessions.<sup>72</sup> However, while such a shift might have the advantage of no longer requiring the rather approximate calculation of future trade flows foregone which are undertaken as part of the expectation measure, determining the precise level of suspension of concessions would still remain a highly complex endeavour, potentially failing to provide reliable incentives to WTO members on whether to breach a WTO rule or not.

It obviously cannot be excluded that some breaches of WTO rules in the past have indeed been efficient, independent of whether one compares only the political welfare of the parties involved (in a public choice approach) or their general public welfare (accounting for all effects of protectionism, including for private persons who do not currently possess the right to sue states for damages at the WTO). What can be excluded with certainty is that the DSU under its current state has been designed to encourage only efficient breach.

It should be stressed that this conclusion remains the same if one were to take only changes in political welfare into account. As demonstrated very convincingly by Sebastian,<sup>73</sup> even in such circumstances, the doctrine of efficient breach is of little value for analysing WTO dispute settlement. As noted above, Schwartz and Sykes have argued, in a public choice approach, that the determination of WTO 'damages' by independent arbitration ensures that the level of suspensions of concessions by the injured Member is precisely equal to the decline in political welfare experienced by it as a consequence of the breach. As a result, the violating Member will only insist on breaching the rules, if the breach is efficient, i.e. if it produces an increase of joint political welfare. As demonstrated by Sebastian however, nothing in the DSU ensures that authorized retaliation for a loss in political welfare of, for example, one million dollars, does not lead to a loss in political welfare for the breaching Member that greatly exceeds one million dollars, thereby possibly deterring an otherwise efficient breach:

The level of decline in political welfare experienced [by the breaching Member] as a result of retaliation will depend critically on the imported products that are affected. The political effects of an import ban that blocks imports worth one million dollars from a single low-margin, non-labour-intensive industry will be very different from an import ban that blocks imports worth one million dollars from fifteen labour-intensive, high-margin industries in

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<sup>72</sup> Collins, *supra* note 22.

<sup>73</sup> Thomas Sebastian, *World Trade Organization Remedies and the Assessment of Proportionality: Equivalence and Appropriateness*, 48 HARV. INT'L L.J. 337 (2007).

politically sensitive states. [Under DSU Article 22.7,] arbitrators are explicitly barred from policing these choices and, as a consequence, it is impossible for [them] to ensure that WTO Members make efficient decisions about whether to perform or breach.<sup>74</sup>

Importantly, modifying Article 22.7 of the DSU so as to equip arbitrators with the right to direct WTO Members in the selection of the products that will be subject to retaliation would not change the overall picture. Various key features of the DSU, notably the expediency of dispute settlement or the reliance on independent arbitration for determining the amount of trade retaliation, certainly help WTO Members in avoiding a waste of resources by settling their disputes in a timely and effective manner. This may certainly be considered as enhancing the efficiency of the world trading system. Nevertheless, in light of the dual inefficiency of WTO ‘damages’ assessment addressed above, one should conclude that the WTO’s dispute settlement mechanism has not been designed to encourage efficient breach.

It still remains, however, that the current design of the DSU tolerates, *de facto*, at least temporary non-compliance. As will be elaborated in the following section, instead of constituting a weakness of the current design of the DSU, this feature should be more properly regarded as one of the system’s strengths since it operates as a highly valuable systemic safety valve.

#### V. COMPLIANCE—YES, BUT NOT AT EVERY COST: *DE FACTO* TOLERATION OF TEMPORARY NON-COMPLIANCE AS A SYSTEMIC SAFETY VALVE

As noted earlier, the weak back-up enforcement under the rules of the DSU does not force WTO Members into compliance,<sup>75</sup> but tolerates, *de facto*, that a member remains in breach for as long as that member accepts to pay the price of non-compliance.<sup>76</sup> It is important to stress at this point that the cost of remaining in non-compliance with WTO law is not limited to the value of compensation or of proportional countermeasures as determined under the rules of the DSU. The

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<sup>74</sup> *Id.* at 375-76.

<sup>75</sup> As would be the case, for example, if the DSU contained a rule analogous to that in Article XXVI:2 of the Articles of Agreement of the International Monetary Fund (IMF) threatening to expel from the WTO every Member that does not comply with the DSB’s recommendations and rulings within a specified timeframe.

<sup>76</sup> The infamous banana dispute (formally covering several WTO disputes) is certainly the outstanding example in this regard. In this dispute, in which the WTO Appellate Body had ruled as early as in September 1997 that the EU’s import regime for bananas was inconsistent with WTO rules (the issue had been contested under the former GATT since 1991), a final agreement between the parties was only reached over twelve years later, on Dec. 15, 2009. See [http://www.wto.org/english/news\\_e/pr591\\_e.htm](http://www.wto.org/english/news_e/pr591_e.htm).

reputational cost of persisting in non-compliance in a legal system characterized by an overall strong compliance record is generally regarded as a powerful incentive to comply. As succinctly phrased by Guzman, “[a] reputation for compliance with international law is valuable because it allows states to make more credible promises to other states. This allows the state to extract greater concessions when it negotiates an international agreement”.<sup>77</sup> This reputational cost can be expected to increase with the duration of non-compliance. Article 21.6 of the DSU plays an important role in this respect since it stipulates that the issue of implementation of the DSB’s recommendations or rulings shall be placed on the agenda of DSB meetings after six months following the date of establishment of the reasonable period of time according to Article 21.3 of the DSU, and shall remain on the agenda of DSB meetings until the issue is resolved. The final sentence of Article 21.6 of the DSU obliges all WTO members concerned to provide a written status report on their progress with respect to the implementation of the DSB’s recommendations and rulings ahead of each such DSB meeting, and every other WTO member can comment on this report at the meeting.<sup>78</sup> This rule has certainly not prevented some WTO members in the past from presenting dozens of status reports containing little news on progress with the implementation.<sup>79</sup> It seems obvious, however, that in a legal system with permanently on-going negotiations at various levels, being perceived as a notorious rule-breaker comes at a considerable present and future cost for any member, including the most powerful ones. Article 21.6 of the DSU is certainly a significant factor in this dynamic.<sup>80</sup>

The fact that a WTO Member found in breach does not, *de facto*, have to establish compliance at any cost by the end of the ‘reasonable period of time’ as set under the rules of Article 21.3 of the DSU, and that it can opt to ‘buy’ additional

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<sup>77</sup> Andrew T. Guzman, *Reputation and International Law*, 34 GA. J. INT’L & COMP. L. 379, 383 (2006). On the role and importance of reputational concerns, see also ROBERT SCOTT & PAUL STEPHAN, *THE LIMITS OF LEVIATHAN* 121 (Cambridge Univ. Press 2006); and Pauwelyn, *supra* note 44, at 166-69.

<sup>78</sup> According to Article 2.3 of the DSU, the DSB shall meet as often as necessary to carry out its functions. In practice, the DSB has a regular meeting every month and additional special meetings can be requested by WTO Members so as to enable them to exercise their full rights under the time procedural time frames laid down in the DSU. See VAN DEN BOSSCHE, *supra* note 15, at 124.

<sup>79</sup> To give just one example, on 14 October 2011, the United States submitted its 107<sup>th</sup> status report in the dispute *United States – Section 211 Omnibus Appropriations Act of 1998*, noting merely, as it had done in previous reports, that the US Administration will continue to work on a solution that would resolve the matter. See WT/DS176/11/Add.107, available at: <http://docsonline.wto.org>. The DSB adopted its recommendations and rulings in that dispute almost ten years ago, on 2 February 2002.

<sup>80</sup> For a detailed, highly insightful, analysis of this and other informal remedies in the context of WTO dispute settlement, see Trachtman, *supra* note 19, at 141-45.

time in exceptional circumstances, constitutes not a weakness, but one of the strengths of the WTO legal framework. On the one hand, there is little doubt that long-term non-compliance would be highly damaging for the system as a whole, eroding the reliability of WTO law and therefore the essential welfare-procuring mechanism of gradual trade liberalization. In other words, long-term non-compliance, particularly if it does not occur in an isolated case but on a large scale, can be expected to entail a creeping erosion of confidence in the multilateral trading system. This, in turn, may lead to a higher level of protectionism and frequent violations of the existing legal framework, thereby rendering any further welfare-enhancing liberalization of the multilateral trading system impossible. Why would WTO members be willing to make new concessions if the rules of the game were notoriously being broken? On the other hand, it appears equally valid to say that the existing avenues for both intra and extra-contractual flexibility as analysed in this article are of crucial importance in order to secure the continuous adherence of sovereign states to a constraining and complex legal framework like the WTO Agreement. They are also of crucial importance in preventing the success of future rounds of trade liberalization from being endangered by discouraging WTO members from making ambitious commitments in the future.<sup>81</sup>

Hence, whereas the flexibility enjoyed by WTO Members under the rules on renegotiation and unilateral modification of tariff and services schedules under Article XXVIII of the GATT 1994 and Article XXI of the GATS respectively is an explicit part of the WTO bargain, the *de facto* accommodation of extra-contractual flexibility under the rules of the DSU constitutes an important systemic safety valve for scenarios where it is impossible for a WTO Member to make quick enough progress with the implementation of the DSB's recommendations and rulings, due to capacity constraints or due to exceptionally fierce domestic resistance. As analysed above, from a strictly legal point of view, such temporary non-compliance cannot lead to a permanent shift of entitlements. Only specific performance, i.e. full compliance with the DSB's recommendations or rulings, or else a mutually agreed solution in the sense of Article 3.6 of the DSU, will lawfully terminate a WTO dispute.

It appears convincing to conclude from the excellent compliance record of the WTO's dispute settlement mechanism, as presented in the introduction, that the seemingly weak back-up enforcement under the rules of the DSU, as strengthened by powerful informal remedies such as reputational concerns operate as a reasonably balanced and very effective incentive for WTO members to comply. It is reassuring for WTO Members to know that they will neither be expelled from the WTO altogether nor have to face massive trade retaliation or face an order to

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<sup>81</sup> On the need for flexibility in international agreements to attract participation and prevent exit, see PAUWELYN, *supra* note 46, at 67-68.

pay punitive ‘damages’ in the event that they find it temporarily impossible to comply with, for whatever reason, the DSB’s recommendations and rulings. This temporary toleration of non-compliance constitutes a valuable systemic safety valve in the absence of which the international community may be faced with a less liberalized global trading system.<sup>82</sup> Here again, the system’s excellent compliance record seems to indicate that WTO Members do not make excessive use of this safety valve, but that they rely on it only under truly exceptional circumstances.

## VI. CONCLUDING REMARKS

It emerges from the analysis provided in this article, that although the WTO’s dispute settlement mechanism has not been designed to encourage efficient breach, the existing system accommodates, *de facto*, at least temporary non-compliance. The current design of the WTO’s dispute settlement mechanism, by operating temporarily as a system of ‘breach and pay’, fulfils a crucial role as a systemic safety valve for rare scenarios where WTO members find it impossible to comply with the DSB’s recommendations and rulings within the ‘reasonable period of time’ as determined according to Article 21.3 of the DSU. The review of the existing avenues for both intra- and extra-contractual flexibility provided in this article, analysed in the light of the excellent compliance record of the WTO’s dispute settlement mechanism, supports the conclusion that the WTO legal framework provides WTO Members with just enough flexibility, both within the boundaries of the existing bargain and beyond them, to ensure that sovereign states remain willing to surrender large parts of their freedom of action in trade matters by adhering to the WTO in the first place and to participate in future rounds of trade liberalization.

In light of the above, and for both the legal and economic reasons discussed throughout this article, one can only conclude that several standard suggestions encountered in the existing literature are misguided. Most importantly, any calls for equipping the WTO’s dispute settlement process with tougher sanctions, in order to force WTO Members who are found to be in breach into immediate compliance, may be perfectly consistent with the legal nature of dispute settlement reports as binding international obligations. However, they entirely overlook that the seemingly weak enforcement mechanism of WTO dispute settlement, with its *de facto* accommodation of temporary ‘breach and pay’, serves as a valuable systemic safety valve. At the same time, reform proposals aimed at overcoming the dual inefficiency of ‘damages’ assessment in WTO dispute settlement in order for the system to encourage only efficient breach suffer from two main shortcomings. On the one hand, they underestimate the importance of a good compliance record

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<sup>82</sup>See, for example, Bello, *supra* note 20; and PAUWELYN, *supra* note 46, at 144.

for the willingness of WTO members to participate in future rounds of trade liberalization. On the other hand, they disregard the fact that under the existing legal framework, persistent non-compliance with WTO dispute settlement reports cannot seal a permanent shift of entitlements, since under the rules of the DSU, WTO law is best analysed as being protected by a property rule and not by a liability rule.

At least with respect to the features discussed herein, the current design of the DSU appears to accommodate, in a very balanced manner, both a certain amount of extra-contractual flexibility and a high degree of legal certainty for both WTO Members and private persons who are clearly the ones to benefit most from an increasing liberalization of world trade.