Abstract

Since the inception of the World Trade Organization (‘WTO’) 15 years ago, there has been much academic debate about the extent to which efficient breach of WTO rules is or should be encouraged under the current state of the provisions governing WTO dispute settlement. This debate is grounded in the widespread recognition that there are significant conceptual parallels between incomplete private contracts and international trade agreements. This paper shows that the conventional application of the doctrine of efficient breach to WTO rules fails essentially on the following two grounds: various inefficiencies linked to WTO ‘damage’ assessment and the erroneous characterisation of WTO rules as being protected by a liability rule. Relying on the seminal concept of entitlements as established by Calabresi and Melamed, this paper argues that WTO rules should be properly analyzed as inalienable entitlements ex post (i.e. during a formal dispute following a breach), but as renegotiable and thus protected by a liability rule ex ante (i.e. in the context of the existing provisions for a modification of scheduled commitments). In addition, the analysis provided with this paper sheds some fresh light on the debate on whether and how to reform WTO dispute settlement. The paper recommends that instead of trying – in vain – to accommodate efficient breach, priority should be given to further improving the compliance record of the system by introducing the threat of formal sanctions similar to those that the International Monetary Fund (‘IMF’) can rely on.

Table of Contents

1. Introduction .................................................................................................................. 2
2. The doctrine of efficient breach and WTO dispute settlement: on the need for a reassessment ........................................................................................................................................................................ 5
3. The failure of the conventional analysis to account for the dual inefficiency of ‘damage’ calculation in WTO dispute settlement........................................................................................................ 10
4. Rethinking the nature of WTO rules: inalienable ex post, but renegotiable ex ante ........................................................................................................................................................................ 15
5. Conclusion .................................................................................................................... 20
‘Models can be mistaken for the total view of phenomena, like legal relationships, which are too complex to be painted in any one picture.’

Guido Calabresi and A. Douglas Melamed

1.

Introduction

Over the 15 years of its existence, the dispute settlement mechanism of the World Trade Organization (‘WTO’), as set out in the Understanding on Rules and Procedures Governing the Settlement of Disputes (‘DSU’) has often, and rightly, been described as the cornerstone of the WTO legal framework. At the same time, theory and practice of the DSU have been subject to intense scrutiny by both WTO Members and academics analyzing the deficits of the system’s current design and advancing proposals for reform, in particular with respect to the issues of remedies and enforcement. This constantly growing body of literature can be roughly divided into three categories: (i) essentially legal research analyzing potential changes to the rules contained in the DSU, with a strong focus on how to achieve better compliance and on how to diminish existing disadvantages of poor and small WTO Members in the dispute settlement process; (ii) political economy research scrutinizing potential modifications of the existing enforcement mechanism, either through the lens of public choice

---


3 There are ongoing negotiations on reforming the DSU as part of the Doha round launched in 2001. An initial review has started as early as in 1997, but so far no final agreement has been reached. For the publicly available proposals by WTO Members, see <http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm#negotiations> (accessed 18 December 2009). In addition, a very useful overview of the current state of these negotiations can be found on the website of the Institute of International Economic Law at Georgetown University: <http://www.law.georgetown.edu/iiel/research/projects/dsureview/synopsis.html> (accessed 4 January 2010).

4 In addition, there is an ongoing debate within the WTO about, and a significant amount of both legal and economic research has been undertaken on, the issue whether, and if yes, the extent to which the presently entirely intergovernmental dispute settlement mechanism should allow for increased participation of private persons (either via a firm right to submit amicus curiae briefs or via creating the possibility for private standing as parties or third parties). These issues are not part of the analysis provided with this paper.

or global welfare, and (iii) law and economics research focussing on the application of the doctrine of efficient breach to WTO law, thus building on analogies to private contract theory. Due to the strong need to accommodate the strongly interdisciplinary nature of international trade law and politics, large parts of the literature obviously have to address crosscutting issues as part of their analysis. This holds true for this paper, too.

This paper aims to contribute to a better economic understanding of the present structure of the rules and procedures of the DSU. The analysis provided in the following calls into question the economic soundness of applying the doctrine of efficient breach to WTO rules. If one takes into account what I call the dual inefficiency of ‘damage’ calculation in WTO dispute settlement – arising from the absence of retroactive damages and the imprecision of damage assessment – the scope for efficient breach of WTO rules appears extremely limited. Furthermore, I argue that the existing literature on efficient breach of WTO rules errs in its analysis of WTO rules as being protected under the DSU by a liability rule. I argue that under the DSU, WTO rules should more appropriately be characterized as ‘inalienable entitlements’, the third, and often-neglected category described by Calabresi and Melamed in their seminal concept of entitlements. The analogy to a liability rule as used in the conventional literature appears convincing only with respect to the protection of WTO entitlements ex ante, i.e. in the context of the rules on renegotiation and modification of scheduled commitments.

Prior to entering into the main analysis, it appears necessary to provide at least a very succinct overview of the relevant rules and procedures of WTO dispute settlement whose

---


8 G Calabresi and AD Melamed (n 1).
most important features can be summarized as follows.\textsuperscript{9} Once a non-appealed panel report or a report by the Appellate Body has been adopted by the WTO Dispute Settlement Body (‘DSB’), the Member whose measures have been found to violate WTO rules will have to state whether and how it intends to comply with the DSB’s recommendations and rulings.\textsuperscript{10} If it is impracticable to comply immediately, the loosing party will be given a reasonable period of time, with the latter being decided either by mutual agreement between the parties and approval by the DSB or through binding arbitration. In any event, the DSB will keep the implementation under regular surveillance until the issue is resolved.\textsuperscript{11}

Additional provisions set out rules for compensation or the suspension of concessions as temporary measures in case the Member found to be in breach does not comply immediately. Within a specified time frame, parties can enter into negotiations to agree on mutually acceptable compensation.\textsuperscript{12} Although the DSU does not forbid that it be pecuniary in nature, compensation usually takes the form of an equivalent lifting of trade barriers by the loosing party. Where this has not been agreed, the winning party to the dispute may request authorization of the DSB to suspend concessions or other obligations, in other words, to unilaterally raise trade barriers.\textsuperscript{13} Disagreements over the proposed level of suspension may again be referred to binding arbitration.\textsuperscript{14} In any event, the level of the suspension of concessions authorized by the DSB shall be equivalent to the level ‘of the nullification and impairment’, in other words, to the amount of protectionism arising from the governmental measure that has been found to violate WTO rules.

The DSU does not provide for retroactive compensation for the economic harm a Member suffered from a WTO-inconsistent measure. Under the current system, compensation and suspension of concessions merely provide some rebalancing in case a Member is found to

\textsuperscript{9} For a detailed presentation and analysis of the rules and procedures contained in the DSU, see for example WTO, \textit{A Handbook on the WTO Dispute Settlement System} (CUP, Cambridge 2004) or, in French, E Canal-Forgues, \textit{Le règlement des différends à l’OMC} (3rd edn Bruylant, Brussels 2008).

\textsuperscript{10} Article 21.3 of the DSU.

\textsuperscript{11} Article 21.6 of the DSU.

\textsuperscript{12} Article 22.2 of the DSU.

\textsuperscript{13} In principle, concessions should be suspended in the same sector as that in issue in the dispute at hand (Article 22.3(a) of the DSU). If this is not practicable or effective, the suspension can be made in a different sector of the same agreement (Article 22.3(b) of the DSU). 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 agreement (Article 22.3(c) of the DSU). The last two cases are usually referred to as cross-retaliation, although officially, neither the terms ‘retaliation’ nor ‘sanctions’ are used in the DSU.

\textsuperscript{14} Article 22.6 of the DSU.
be still in non-compliance after the ‘reasonable period of time’ that it was accorded by the DSB in order to make the necessary legislative or regulatory changes has expired. The DSU makes it clear that both compensation and the suspension of concessions are only temporary measures with compliance remaining the ultimate goal of WTO dispute settlement.15 Another central provision of the DSU, intended to strengthen the multilateral system, reaffirms that Members shall not themselves make determinations of violations or suspend concessions, but shall make use of the dispute settlement rules and procedures of the DSU.16

Turning now to the main analysis, this paper will proceed as follows: After a review of the doctrine of efficient breach and its conventional application to WTO dispute settlement (Section 2), the failure of the conventional analysis to sufficiently account for the dual inefficiency of ‘damage’ calculation in WTO dispute settlement will be analyzed (Section 3). Subsequently, the paper argues that WTO rules should appropriately be qualified as inalienable ex post, but renegotiable ex ante (Section 4). The main implications of this analysis for the academic debate on DSU reform are summarized in the conclusion.

2. **The doctrine of efficient breach and WTO dispute settlement: on the need for a reassessment**

According to the economic theory of contract remedies, it is not efficient for the parties to very complex agreements to determine in advance how they ought to behave under every conceivable contingency. Circumstances might thus arise in which it is in the parties’ joint interest to facilitate an efficient breach of commitments. As has been summarized elsewhere:

> Economic theory teaches that a key objective of an enforcement system is to induce 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.17

In other words, efficient breaches should be encouraged; only inefficient ones should be deterred.18

---

15 Article 22.1 of the DSU.
16 Articles 23.1 and 23.2 of the DSU.
17 W Schwartz and A Sykes (n 7) 181.
The precise way in which this overarching objective is to be achieved, i.e. the optimal design of enforcement mechanisms, crucially depends on the nature of the underlying legal rule. As elaborated by Calabresi and Melamed in their seminal concept of entitlements, rights 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. An entitlement protected by a property rule cannot be taken from its holder unless the latter is willing to sell it, at a price reflecting how he subjectively values the property. In contrast, 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. Inalienable entitlements are those for which the sale of property is not permitted, even between a willing buyer and a willing seller.

Concerning the choice of the right type of entitlement protection, the conventional wisdom held for many years that allocation by the market is generally cheaper than allocation by the law when transaction costs are low. In other words, where transactions 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 for many years in academic writing, and this despite the fact that Polinsky had shown as early as in 1980 that transaction costs were not the only impediment to bargaining, but that the costs linked to the assessment of damages created a significant problem. Measurement of damages by a court is almost always costly. In addition, there is the risk that the court makes mistakes in its damages assessment. This is highly problematic, because if damages are too low, they will encourage inefficient breach or, if they are too high, they will deter efficient breach.

---

19 G Calabresi and AD Melamed (n 1) 1105-6.

20 Ibid, 1111-1115.

21 As put by Richard Posner in the first edition of his famous textbook on law and economics, ‘where transaction costs are high, the allocation of resources to their highest valued uses is facilitated by denying property right holders an injunctive remedy against invasions of their rights and instead limiting them to a remedy in damages…’ (R Posner, Economic Analysis of Law (1st edn, 1972) 29 (quoted in J Krier and S Schwab, ‘Property Rules and Liability Rules: The Cathedral in Another Light’ (1995) 70 NYU Law Review 440, 452 and n 43)).

22 For a detailed discussion and references, see J Krier and S Schwab (n 23) 452-5.


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.25

The parties to an incomplete private contract wishing to avoid only inefficient breach are thus generally left with the following options:

In the case of entitlements that are properly protected by a property rule and where thus transaction costs are sufficiently low, the party wishing to deviate from the rule can always enter into a renegotiation of the specific entitlement with the other party concerned in order to determine whether there is scope for efficient breach. According to the theory of efficient breach, the party interested in breaching the rule should be able to obtain permission from the other party to do so by paying a pecuniary compensation if the value of the breach to it exceeds the value of performance to the other party. In the contrary, if the harm arising from breach exceeds its value, there will be a clear incentive for efficient performance. The 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). Theory requires that any violation of an order for specific performance would be punished so severely that the party concerned will always prefer to perform unless it can successfully renegotiate with the other party.

The second mechanism allowing for efficient breach functions via the award of damages and concerns entitlements that are properly protected by a liability rule. The common law of contracts disposes of three alternative damage measures that correspond to three different interest of the harmed party: restitution,26 reliance,27 and expectation. Whereas both restitution and reliance measures aim to put the harmed party in as good a position as it was before it entered into the contract, the objective of expectation damages is to put the

25 J Krier and S Schwab (n 23) 454 (footnote omitted, original emphasis).
26 The restitutionary measure requires that any benefits, pecuniary or under other form, that the harmed party transferred to the breaching party between the formation of the contract and its breach be returned.
27 Any costs that have arisen to the harmed party because it relied on the performance of the contract can be recovered as reliance loss.
harmed party into as good a position as it would have been had the contract been properly
performed. 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 only breach the contract if it gains more
from the breach than the other party loses. In practice, however, it is far from certain that the
use of expectation damages will encourage breach only where it is efficient. The estimation of
lost future profits arising from missed performance can be a highly complicated task. The
costs arising from litigation and damage assessment by the court further blur the picture as
discussed above.

Since the inception of the WTO there has been much academic debate about the extent
to which efficient breach of WTO rules is encouraged under the current state of the DSU.
This debate is grounded in the widespread recognition that there are significant conceptual
parallels between incomplete private contracts and international trade agreements. Warren
Schwartz and Alan Sykes, for example, approaching the issue from the viewpoint of public
choice, have perfectly characterized 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.

Whereas this convincingly explains the existence of explicit provisions in the WTO
treaty text for the modification of schedules via renegotiation (as provided notably in Article
XXVIII of the General Agreement on Tariffs and Trade (‘GATT’) 1994 and in Article XXI of
the General Agreement on Trade in Services (‘GATS’)) prior to any dispute, academics

28 For a detailed presentation of these three different measures with illustrating examples, see T. Ulen, ‘The
Law Review 341, 356-64.
29 For detail, see for example J Barton, ‘The Economic Basis of Damages for Breach of Contract’ (1972) 1
Journal of Legal Studies 277, 283-9, R Birmingham (n 20) 284-6, S Shavell, ‘Damage Measures for Breach of
30 On this view, see also D Collins (n 7), 230-2, (n 26). Again, if the damages that the breaching party has to pay
fall short of the real total cost arising from the breach, it is inefficient breach that is thus encouraged. However, if
the damages are set at too high a level, they deter breach that would have been efficient.
31 W Schwartz and A Sykes (n 7) 184.
32 For detailed developments on the issue of renegotiation, see section 4 of this paper.
remain divided on the question to what extent efficient breach is accommodated, or should be accommodate by the DSU, if not de iure, so de facto.

From a strictly legal point of view, eminent writers like John Jackson and Joost Pauwelyn have argued that the DSU should be interpreted as imposing a strict obligation to comply with the DSB’s recommendations and rulings and that the idea of efficient breach is thus unconceivable.\(^{(33)}\) Other writers, mainly from the field of law and economics, have insisted that the language of the present DSU is sufficiently imprecise to leave some scope for efficient breach.\(^{(34)}\) Yet others accept the legal analysis that compliance with the DSB’s recommendations and rulings is mandatory, but argue that de facto the DSU leaves room for potentially efficient breaches, as it cannot be excluded, under the current legal framework, that a Member found to be in breach prefers to be retaliated against indefinitely instead of establishing compliance.\(^{(35)}\) Among the above and in addition, a few articles have expressed scepticism about the economic soundness of applying the doctrine of efficient breach to WTO dispute settlement under its current shape.\(^{(36)}\)

For any economic analysis it is of little relevance whether the DSU in its current shape is merely sufficiently ambiguous to accommodate opportunities for efficient breach or whether it merely does so de facto. It seems, however, that not enough attention has been devoted yet to the question whether there are key features in WTO dispute settlement that make it impossible for any WTO Member to successfully distinguish between efficient and inefficient breaches. In the following section, I therefore argue that the conventional law and economics analysis of efficient breach of WTO rules is flawed by not sufficiently accounting for the dual inefficiency of ‘damage’ calculation in WTO dispute settlement and that, as a result, applying the doctrine of efficient breach to WTO rules, is of only little value.

---


\(^{(34)}\) See for example D Collins (n 7), A Green and M Trebilcock (n 5), W Schwartz and A Sykes (n 7) 188-192 (on these pages, Schwartz and Sykes explicitly discuss and, as I find, fail to successfully refute Jackson’s legal analysis with respect to mandatory compliance with WTO rules), A Sykes (n 7).


\(^{(36)}\) See for example D Collins (n 7), T Sebastian, ‘World Trade Organization Remedies and the Assessment of Proportionality: Equivalence and appropriateness’ (2007) 48 Harvard ILJ 337, J Trachtman (n 7), H Spamann (n 5), A Sykes (n 7). See section 3 below for detail on the economic criticism of applying the doctrine of efficient breach to WTO rules.
3. The failure of the conventional analysis to account for the dual inefficiency of ‘damage’\textsuperscript{37} calculation in WTO dispute settlement

The way that ‘damages’ are calculated in WTO dispute settlement possesses two essential characteristics that, if properly accounted for, lead to the breakdown of the conventional analysis of efficient breach of WTO rules.

To begin with, as a consequence of the absence of retroactive ‘damages’ under the DSU, applying the doctrine of efficient breach to WTO rules is highly likely to lead to wrong results. As noted previously, the losses that cannot be recovered can be impressive. The dispute may have been pending before the competent panel for years with the protectionist measure continuing to produce its harmful effects. The time needed for an appeal and various arbitrations may have further increased the losses for which the harmed 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 having ever to compensate the loss it inflicted on another Member. Under these circumstances, and putting aside for the moment potentially important other factors that diminish the total value for the violator state of breaching WTO rules (like reputational costs and domestic pressure for compliance) it seems highly likely that at least some of the breaches that occur are in fact not efficient at all. In the absence of retroactive ‘damages’, a significant proportion of the economic harm caused to another member can be ignored by the breaching Member when it decides whether or not to abide by the rules.

The existing literature does obviously not ignore the absence of retroactivity, but it fails to take it properly into account when applying the doctrine of efficient breach to WTO rules. Schwartz and Sykes, for example, approach the issue by arguing very convincingly as follows:

\begin{quote}
[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
\end{quote}

\textsuperscript{37} As noted in the introduction to this paper, WTO dispute settlement in its current state allows for either mutually agreed compensation or the suspension of concessions or other obligations in case the Member found to be in breach still refuses to comply after the ‘reasonable period of time’ as determined in accordance with Article 21.3 of the DSU. However, in analyzing the economic soundness of applying the law and economics doctrine of efficient breach to WTO rules, it appears appropriate to use the term ‘damages’, since this entire approach is built on an analogy to private contract theory.
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 behavior 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.\textsuperscript{38}

Schwartz’s and Sykes’s claim that many violations of WTO rules involve good-faith behaviour seems very plausible. As demonstrated by the two authors, domestic political cost of violations, reputational concerns, and the threat of unilateral sanctions contributed significantly to the high level of compliance witnessed throughout the GATT years,\textsuperscript{39} and nothing indicates that these mechanisms are no longer important reasons for the good compliance record of WTO dispute settlement.\textsuperscript{40} However, the fact that the founders of the WTO renounced on imposing retroactive ‘damages’ still very much appears as a choice guided not mainly by purely economic, but by political motivations, albeit entirely sensible ones. If one assumes that poor WTO Members, due to 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 the appearance of further disadvantages for poorer Members in WTO dispute settlement. This point alone might already justify the absence of retroactive ‘damages’. Additional economic considerations as the ones noted by Schwartz and Sykes further confirm this choice as a sensible one.

With respect to the efficiency or inefficiency of breach, it still remains, however, that the absence of retroactive ‘damages’ completely blurs the picture of the overall balance of value and loss arising from a breach. Renouncing on retroactivity and thereby showing lenience with respect to good-faith breaches might have been a politically appropriate choice, which also procures some economic benefit by allowing for the clarification of ambiguous WTO rules via dispute settlement. At the same time, however, good-faith breaches of WTO rules are not less harmful as intentional cheating. Under these circumstances, one cannot but conclude that the application of the doctrine of efficient breach to WTO dispute settlement under its present shape is intellectually not convincing. In the absence of retroactive

\textsuperscript{38} W Schwartz and A Sykes (n 7) 201.
\textsuperscript{39} Ibid 194-200.
\textsuperscript{40} 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 countries.
‘damages’ any claim that WTO dispute settlement encourages only efficient breaches is unsustainable.

This is not the only point, however, where the analogy to private contract theory fails. Even if one entirely disregards the retroactivity issue for the sake of argument, to claim that ‘damages’ as set by WTO dispute settlement will enable WTO Members to make efficient decisions on whether to breach a 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 harmed part, the issue will be decided by binding arbitration. Schwartz and Sykes have interpreted this as the key innovation in the DSU 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 counterthreats 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).

In subsequent work, however, Sykes has acknowledged that the analogy to expectation damages is imperfect and that it fails in other respects, among them ‘the question of how to measure and operationalize “equivalence”’ which, as he rightly notes, ‘is much less clear than in the private contract setting’.

Despite the expectation raised by the straightforward language employed in Article 22.4 of the DSU as cited above, and contrary to the position taken by Schwartz and Sykes, it seems more than likely that in reality the level of WTO ‘damages’ as set by arbitration will at best get close to the level of nullification or impairment. This is mainly due to the difficulty faced by arbitrators of assessing the volumes of future trade foregone. This and related ‘damage’ assessment problems, have been analyzed in detail already elsewhere. The fact

41 W Schwartz and A Sykes (n 7), 203.
42 A Sykes (n 7) 9-16.
that litigation costs are not included in this ‘damage’ assessment further distorts the 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, Collins has suggested in a very recent paper that WTO dispute settlement switch from the current expectation measure to a reliance measure when assessing the level of suspension of concessions.\(^{44}\) It seems plausible to me that such a change would facilitate the assessment of WTO ‘damages’ as it would no longer require the rather approximate calculation of future trade flows foregone. Even then, however, the determination of the level of suspensions of concessions would still be far from being an exact enough business to enable WTO Members to make efficient decisions on whether to breach a rule or not.

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

It should be stressed that this conclusion does not change if one takes only changes in political welfare into account. In another recent article,\(^{45}\) Sebastian demonstrates very convincingly that even then the doctrine of efficient breach is of little value for WTO dispute settlement. As noted above, Schwartz and Sykes had argued, in a public choice approach,\(^{46}\) that the determination of WTO ‘damages’ by independent arbitration ensures that the level of suspensions of concessions by the harmed Member is precisely equal to the decline in political welfare experienced by it as a consequence of the breach. As a consequence, so Schwartz and Sykes, 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, the DSU does not guarantee that authorized retaliation for a loss in

---

\(^{44}\) D Collins (n 7) 233-40.

\(^{45}\) T Sebastian (n 36).

\(^{46}\) W Schwartz and A Sykes (n 7).
political welfare of, for example, one million dollars,\(^{47}\) does not lead to a loss in political welfare in the breaching member that by far exceeds one million dollars, and thus maybe deters an otherwise efficient breach. As illustrated by Sebastian,

> 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-labor-intensive industry will be very different from an import ban that blocks imports worth one million dollars from fifteen labor-intensive, high-margin industries in politically sensitive states. [Under Article 22.7 of the DSU,] 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. \(^{48}\)

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 might be an efficient change, but this would not change the overall picture with respect to efficient breach. In light of the dual inefficiency of ‘damage’ assessment as analyzed in this section, one cannot but conclude that the doctrine of efficient breach does not produce any convincing results in the context of WTO dispute settlement.

This takes me directly into the next section in which I argue that the initial deficit of the conventional literature on efficient breach of WTO rules resides at a conceptually earlier stage. The existing literature on efficient breach of WTO rules, including those articles that have rightly criticised the economic soundness of the approach due to the inefficiency of ‘damage’ assessment in WTO dispute settlement as analyzed above, is characterized by one important deficit. In analogy to private contract theory, WTO rules are commonly analyzed as being protected by liability rules and not by property rules due to high transaction costs.\(^{49}\) The third category of entitlements as originally established by Calabresi and Melamed, inalienable entitlements, is being entirely ignored by the literature. In the following, I explain why the conventional approach appears erroneous and I argue that it is the underlying reason for why applying the doctrine of efficient breach to WTO dispute settlement does not produce any meaningful results.

---

\(^{47}\) Assuming that the arbitrator succeeds, surprisingly, in setting ‘damages’ at a level perfectly equivalent to the loss in political welfare experienced by the harmed Member, and disregarding the distorting effects of the absence of retroactivity in the calculation of ‘damages’.

\(^{48}\) T Sebastian (n 38) 375-6.

\(^{49}\) See for example D Collins (n 7) 227, W Schwartz and A Sykes (n 7) 185-92, A Green and M Trebilcock (n 5) (arguing that liability rules are preferable over property rules in the case of export subsidies).
4. **Rethinking the nature of WTO rules: inalienable *ex post*, but renegotiable *ex ante***

When analyzing the WTO legal framework as an incomplete contract in analogy to private contract theory it would obviously be unrealistic to expect that the characteristics of international trade law fit perfectly into the legal categories established for the common law of contracts. Any analogy can therefore necessarily be only approximate in nature. Even on this basis, however, it seems to me that the existing literature errs in the way it characterizes the protection of WTO rules under the DSU.

To begin with, I perfectly agree with the literature that an analogy to property rights would not adequately characterize the protection of WTO rules. Concerning protection *ex ante*, i.e. before a breach occurs, the WTO rules regarding the renegotiation of schedules\(^{50}\) clearly indicate that entitlements under the WTO legal framework can indeed be taken from their holder at a price that might not reflect how he subjectively values it. Although any WTO Member wishing to withdraw a concession is obliged to negotiate with any other Member having a substantial interest in that concession in order to determine a mutually agreeable compensation, it may go ahead and withdraw the relevant concession if the negotiations over compensation break down. Adversely affected Members have at that point merely the right to withdraw substantially equivalent concessions or obligations;\(^{51}\) they have no legal means to prevent the modification of schedules desired by the other Member. This clearly shows that entitlements under the WTO agreements cannot be characterized as being protected by a property rule.

With respect to renegotiation, i.e. for any modification of individual concessions that occurs outside the scope of a formal dispute, it appears indeed appropriate, in accordance with the existing literature, to characterize WTO rules as being protected by a liability rule. As recalled by Schwartz and Sykes, ‘the magnitude of “liability” is clearly specified—concessions substantially equivalent to those withdrawn by the Member that proceeds [to a modification of its schedule].’\(^{52}\) 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

\(^{50}\) In particular Article XXVIII of the GATT 1994 and Article XXI of the GATS as previously noted.

\(^{51}\) As determined by Article XXVIII:3 of the GATT. 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 (Article XXI:3(a)–4(b) of the GATS).

\(^{52}\) W Schwartz and A Sykes (n 7) 187.
in order to determine how much the destroyer of an entitlement will have to pay to its original holder.53

However, whereas entitlements under the WTO legal framework are correctly analyzed as being protected by a liability rule as far as their modification ex ante via renegotiation is concerned, this same analogy does not appropriately characterize the protection ex post of WTO rules under the DSU. At first sight,54 the fact that the DSU provides for an ‘objective’ assessment by arbitration of the amount of concessions that the harmed Member may suspend if the Member found to be in breach refuses to comply, appears to be a perfect parallel to what happens in the case of renegotiation. The fact that the DSU does not force a Member by all means into compliance,55 but tolerates, de facto, that a Member remains in breach56 for as long as that Member accepts to pay the price of non-compliance,57 further points to the conclusion that, here again, entitlements under the WTO agreements are protected by a liability rule.58 A closer look reveals, however, that it would be erroneous to take such a position.

Characterising the legal protection that is provided under the DSU for WTO entitlements as a liability rule entirely disregards the majority position in the legal community

53 G Calabresi and AD Melamed (n 1) 1105-6.
54 As discussed earlier in this paper, see section 3 and relevant remarks in the introduction above.
55 Like, for example, by formally threatening to expel from the WTO every Member that does not comply with the DSB’s recommendations and rulings within a specified amount of years.
56 The infamous banana dispute (formally covering several disputes) is certainly the outstanding example in this regard. In this dispute, in which the WTO Appellate Body had ruled as early in September 1997 that the EU’s import regime for banana’s 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 on 15 December 2009. See the relevant WTO press release at <http://www.wto.org/english/news_e/pres09_e/pr591_e.htm> accessed 2 March 2010.
57 It is important to stress that the price of non-compliance exceeds the value of compensation or of the suspension of concessions. The reputational cost of persisting in a position of breach in a legal system characterized by an overall strong compliance record is generally regarded as an additional, powerful, force in promoting compliance. The reputational cost can be expected to rise with the duration of non-compliance. Article 21.6 of the DSU plays an important role in this respect as it obliges the Member concerned to provide a written status report with respect to implementation ahead of every regular DSB meeting and every other Member will have the possibility to comment on this report at the DSB’s meeting. Certainly, this rule alone has not prevented that in some case Members have presented dozens of status reports containing little news on progress with implementation. It seems obvious, however, that in a legal system with permanent negotiations at various levels, being perceived as a notorious rule-breaker comes at a considerable present and future cost. Article 21.6 of the DSU is a not insignificant factor in this dynamic. For additional, interesting, comments on the issue of informal remedies, see J Trachtman (n 7) 141-5.
58 For this view, see for example W Schwartz and A Sykes (n 7) 188.
that compliance with the DSB’s recommendations and rulings is strictly mandatory.\(^{59}\) As noted above, the DSU is flexible enough to allow for the temporary recourse to measures like compensation and the suspension of concessions or other obligations\(^{60}\) if the Member found to be in breach cannot re-establish compliance immediately.\(^{61}\) Under such lenient rules it can indeed not be excluded, as has happened already, that a WTO Member remains in a situation of non-compliance for many years. However, this does not alter the fact that that Member remains under a continuous obligation to bring the measures found to be inconsistent with the WTO agreements into compliance.

Contrary to what happens in the scenario of renegotiation and modification of schedules as analyzed above, compensation and the suspension of concessions under Article 22 of the DSU do not seal a final shift of entitlements. The only way to permanently ‘repair’ a breach of WTO rules, and to settle the related dispute, is compliance with the DSB’s recommendations and rulings. Compensation and the suspension of concessions as temporary measures under the DSU are conceptually distinctly different from the payment of damages at the end of a lawsuit. The conventional approach of considering WTO rules as being protected by a liability rule appears appropriate with respect to protection \textit{ex ante} via renegotiation and modification of schedules. With respect to protection \textit{ex post} under the DSU this approach is flawed.

Prior to moving on to what I argue is the appropriate characterisation of the protection \textit{ex post} of WTO entitlements under the DSU, the following point needs to be emphasised. The fact that the protection \textit{ex ante} via renegotiation and modification of schedules has been appropriately characterized by the existing literature as 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. As developed earlier in this paper,\(^{62}\) this depends crucially on the extent to which the assessment of the level of

\(^{59}\) On this issue, the detailed legal analysis provided by John Jackson can be regarded as authoritative expression of an interpretation that is widely adhered to: \textit{J} Jackson, ‘International Law Status of WTO Dispute Settlement Reports: Obligation to Comply or Option to “Buy out”?’ (2004).

\(^{60}\) See Article 22.1 of the DSU.

\(^{61}\) There may be a number of good reasons why a Member cannot comply immediately, like the absence of a functioning government during a civil war, or merely increased domestic pressure from an industry branch whose financial support appears crucial to the government in the next elections. Out of respect of its Members sovereignty, the DSU does not require Members to give any reason for non-compliance and enables them, \textit{de facto}, to ‘buy’ additional time if absolutely necessary.

\(^{62}\) See section 2 above. If ‘damage’ assessment is inefficient, applying the doctrine of efficient breach does not lead to any meaningful results.
compensation or of the suspension of concessions properly reflects the loss that would arise for a Member from the modification of another Member’s schedule. Even in the absence of the two factors that tend to distort the assessment of ‘damages’ under the DSU – litigation costs and the non-retroactivity of compensation – the assessment problems in the context of renegotiation are similarly complex as those encountered under the DSU. As a consequence, even for the limited domain of renegotiation and modification of schedules, relying on the doctrine of efficient breach appears to be of little use.

As noted earlier in this paper, in establishing their seminal concept of entitlements, Calabresi and Melamed included a third category: inalienable entitlements. Although the conventional literature on efficient breach of WTO rules entirely disregards this category, the latter appears to appropriately reflect the way in which WTO entitlements are protected ex post, i.e. under the rules of the DSU. As noted at several occasions throughout this paper, compensation and retaliation are merely temporary measures; ultimately full compliance with the DSB’s recommendations and rulings is required. This perfectly reflects the essential characteristic of an inalienable entitlement: the sale of property is not permitted, even between a willing buyer and a willing seller. Transposed to the context of a WTO dispute this means: even if a Member happily accepted to be compensated forever by another Member for the loss inflicted upon him, and if the Member found in breach were happy to compensate the harmed Member instead of complying, this would not terminate the dispute as can be inferred from Article 3.5 of the DSU.

This means that any settlement of a dispute among the parties needs to be consistent with WTO law. The fact that the schedules of concessions of individual Members can be renegotiated does obviously not mean that the entire body of multilateral legal rules constitutes a legal framework à la carte. To give an example, one could consider a WTO dispute between two Members over a prohibited export subsidy. In accordance with the logic described above, even if the negatively affected Member were happy to let the other Member continue to subsidize as long as it received adequate compensation, this would not suffice in

---

63 See section 3 above.
64 See section 2 above.
65 Stating that: ‘All 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.’
order to officially settle the dispute. The subsidizing Member would still be in breach of a multilateral legal obligation, which it cannot simply negotiate away bilaterally.

It is of course important to ask how this inalienability *ex post* of WTO entitlements under the rules of the DSU can be justified. Why would a specific rule, like the prohibition of export subsidies, that can be modified tomorrow or abolished altogether as a result of multilateral negotiations leading to a consensus on a new design of international trade law, be inalienable, i.e. be set in stone, in the context of a WTO dispute? Here again, it seems to me that Calabresi and Melamed have already provided the answer in their original concept of entitlements. According to Calabresi and Melamed, rendering entitlements inalienable may be justified if a transaction would create significant externalities and, in particular, if these external costs ‘do not lend themselves to collective measurement which is acceptably objective and nonarbitrary.’

Once again, this perfectly characterises the situation encountered under the DSU. Although most disputes at the WTO are essentially bilateral in nature, it seems obvious that persistence in a position of breach – not so much breach itself – creates huge externalities, in the sense of costs for not directly involved parties and the multilateral trading system as a whole. Whereas a good-faith breach of an ambiguous WTO rule might even be regarded as providing a public good in the form of valuable clarification by the DSB if litigated to conclusion, the external costs of longterm non-compliance appear significant. These costs for Members not directly involved in a dispute clearly exceed what will be compensated as a result of the basic principle of non-discrimination enshrined in the most-favoured nation (‘MFN’) clause.

Longterm non-compliance, in particular if it occurs not 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 may lead to a higher level of protectionism in breach of the existing legal framework and render any further welfare-enhancing liberalization of the multilateral trading system impossible. Why would a WTO Member make new concessions if the rules of the games are notoriously being broken?

---

66 G Calabresi and AD Melamed (n 1) 1111.
67 As analyzed by W Schwartz and A Sykes (n 7) 201.
68 The fact that compensation under Article 22.1 of the DSU, if granted, ‘shall be consistent with the covered agreements’, has been analyzed very convincingly by Pauwelyn as implying that such compensation would have to be offered on an MFN basis to all other WTO Members (J Pauwelyn (n 5) n 12).
To be clear, the fact that a Member found to be in breach does not have to comply immediately at any price, but can, in exceptional circumstances ‘buy’ additional time as analyzed earlier in this paper, is probably not only an acceptable, but also a very efficient solution in the eyes of most WTO Members. Longterm non-compliance, however, would be highly damaging for the system as a whole, eroding the reliance of legal commitments and thus the essential welfare-procuring mechanism. It should be obvious that the externalities thus arising do indeed not lend themselves to collective measurement, which is acceptably objective and nonarbitrary as postulated by Calabresi and Melamed.

With respect to their legal protection ex post under the DSU, WTO entitlements should thus correctly be analyzed as inalienable entitlements. This appears to be the only interpretation that accommodates both the dominant legal interpretation of the DSB’s recommendations and rulings as being strictly binding and the findings of economic theory. The fact that the picture is slightly different with respect to the rather limited scope of renegotiation and modification of schedules fits perfectly into the overall analysis. Renegotiation in view of a mutually agreeable shift of entitlements as under Article XXVIII of the GATT or Article XXI of the GATS is distinctly different from an outright breach, longterm non-compliance and the related loss of confidence. On the contrary, it can be expected that the possibility to renegotiate the scope of schedules provides the system with precisely the minimum of flexibility in the absence of which WTO Members might be discouraged from making ambitious commitments in the future.

5. Conclusion

As analyzed in this paper, the conventional application of the doctrine of efficient breach to WTO rules fails essentially on the following two grounds: the described dual inefficiency of ‘damage’ assessment at the WTO and the erroneous characterisation of WTO rules as being protected under the DSU by a liability rule. On the second issue, this paper found that WTO rules should be properly analyzed as inalienable entitlements ex post, i.e. under the DSU, but as renegotiable (and thus protected by a liability rule) ex ante in the context of the existing provisions for a modification of scheduled commitments.

Seen that parts of this paper stand in outright contrast to the existing literature on efficient breach of WTO rules, it appears appropriate to ask whether any general conclusions
can be drawn from the analysis provided herein for the ongoing debate on reforming WTO dispute settlement.\textsuperscript{69}

In response, it seems indeed that the revision of the application of the doctrine of efficient breach to WTO rules undertaken in this paper sheds some fresh light on DSU reform. For any reform it should be kept in mind that it appears highly likely that the DSU under its current state encourages also inefficient breaches due to the described dual inefficiency of WTO ‘damage’ assessment. As analyzed, as long as ‘damages’ are not retroactive in nature, improving the objectivity of the assessment of compensation and the suspension of concessions as temporary measures will alone not suffice in order for the doctrine of efficient breach to be applicable to WTO dispute settlement. Improving the assessment techniques for compensation and the suspension of concessions is obviously still important as it will improve the objectivity and thus the fairness of these temporary measures if a Member cannot comply immediately. As noted above, however, in the absence of retroactive ‘damages’, it does not make sense to approach such a reform with the (declared or secret) objective to accommodate efficient breach. In the light of this, any reform of the DSU should instead be undertaken with the objective to ensure that the record of longterm compliance with the DSB’s recommendations and rulings remains good.

This view is entirely supported by the second main finding of this paper: the DSU in its current state protects WTO rules as inalienable entitlements and not via a liability rule as erroneously analyzed by the existing literature. As argued above, the drafter’s choice to opt for inalienable entitlements is entirely justified by the major present and future externalities that arise from longterm non-compliance for the global trading system. Despite these externalities, it is importance to recall something that has been noted earlier in this paper. In order not to endanger the success of future trade liberalisation, it appears crucial to preserve the flexibility that WTO Members currently enjoy under the rules on renegotiation and modification of schedules and, also, via the possibility, \textit{de facto}, under the DSU, to ‘buy’ some additional time if they cannot comply immediately.

Finally, in order to ensure that longterm non-compliance does not one day become a real problem it might be sensible to strengthen the DSU. So far the system relies almost entirely on informal remedies like the increasing reputational cost of remaining in breach, in order to ensure that the temporary measures that constitute compensation and the suspension

\textsuperscript{69} For useful references on the existing literature on DSU reform, see n 3-7 above.
of concessions and other obligations remain indeed temporary.\textsuperscript{70} Although the system is so far characterized by a rather impressive compliance record, having no formal means at all to force a Member into compliance might be considered a quite risky approach and a potential weakness of the DSU.

WTO Members might therefore want to consider introducing a limited number of sanctions similar to those that can be found in Article XXVI:2 of the Articles of Agreement of the International Monetary Fund (‘IMF’). According to this provision, the IMF may, if a member fails to fulfil any of its obligations under the Fund Agreement, suspend that member’s voting rights and, ultimately even expel that member from the organization.\textsuperscript{71} In order to avoid scenarios of longterm non-compliance with their damaging consequences as analyzed in this paper, it might be in the common interest of all WTO Members to introduce similar sanctions into the DSU. Their application should obviously remain limited to extreme cases of persisting refusal to comply, like for example 5 and 10 years respectively since the final ruling in a dispute. Similarly long time frames would still leave WTO Members with enough flexibility to accommodate temporary domestic difficulties to comply. Ideally, already existing informal mechanisms like reputational costs would ensure that these draconian sanctions would never have to be applied in practice. Introducing them as credible threat, as a means of last resort, however, appears sensible in light of the analysis provided in this paper.

\textsuperscript{70} Strictly speaking, under the current system, compensation and the suspension of concessions do not have the character of compliance-inducing sanctions as their value may not exceed the value of the nullification or impairment (Article 22.4 of the DSU).

\textsuperscript{71} In an additional first step, the IMF member concerned may be declared ineligible to use the Fund’s financial resources but this is obviously a provision that is IMF-specific and therefore of little relevance for the WTO context.