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Tariff retaliation versus financial compensation in the enforcement of international trade agreements ☆

Nuno Limão [a,*,1], Kamal Saggi [b,2]

[a] University of Maryland, Department of Economics, CEPR, NBER, United States
[b] Southern Methodist University, United States

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ABSTRACT

We analyze whether financial compensation is preferable to the WTO's current dispute settlement system that permits injured member countries to impose retaliatory tariffs. We show that, ex-post, monetary fines are more efficient than tariffs in terms of granting compensation to injured parties but fines suffer from an enforcement problem since they must be paid by the violating country. If fines must ultimately be supported by the threat of tariffs, they fail to yield a more cooperative outcome than the use of tariffs alone. Furthermore, the exchange of bonds between symmetric countries also does not improve enforcement relative to retaliatory tariffs.

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1. Introduction

One of the major goals of the World Trade Organization (WTO) is to reduce policy barriers to international trade. Yet, its dispute settlement system allows members to raise tariffs in response to trade violations committed by other members. Although retaliation is permitted only as a last resort, the fact that the WTO even permits tariff increases appears to be a direct contradiction of its goal of freer trade. This contradiction as well as the fact that many small countries cannot effectively retaliate via tariffs have lead to calls for alternative trade dispute remedies.[3]

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* Corresponding author. Tel.: +301 405 7842.
E-mail addresses: limao@econ.umd.edu (N. Limão), ksaggi@smu.edu (K. Saggi).

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2 Tel.: +214 768 3274.

3 See Hoekman and Kostecki (2001) for a good overview of the WTO's dispute settlement procedures. Lawrence (2003) notes that WTO rules are designed to preserve the existing balance of concessions (i.e. to maintain reciprocity). Ethier (2003) argues that the role of the WTO's dispute settlement procedure is “not to facilitate punishment: It is to constrain it.”

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There are at least two possible reasons why the WTO's Dispute Settlement Understanding (DSU) permits tariff retaliation. First, the threat of retaliation might encourage members to comply with WTO rules: in the absence of any fear of foreign retaliation, members would be tempted to raise their trade barriers whenever so urged by their import lobbies. Second, tariff retaliation may allow an injured country to obtain partial compensation by either improving its terms-of-trade and/or by benefiting those import competing sectors that are favored due to political economy considerations. Of course, even if tariff retaliation helps enforce cooperation and/or enable compensation in trade agreements, it may not necessarily be the optimal instrument for achieving these objectives. In principle, monetary fines payable by a country that violates WTO rules could have both a deterrent effect and a compensatory one while simultaneously avoiding the well-known inefficiencies of tariffs. Our goal in this paper is to evaluate whether the use of fines and bonds can improve upon the WTO's current dispute settlement system based on retaliatory tariffs.

The idea that trade disputes be settled via financial compensation has gained substantial attention in recent years with several new proposals to reform the DSU in the Doha Round, which is still under way.[4] Similar proposals were made in the early 1960s by Uruguay and Brazil who wanted less developed countries to be provided with financial compensation for GATT violations committed by developed countries. Moreover, as .Dam (1970) notes, the principle of financial liability to injured parties underlies domestic laws across the world and its use in international law seems natural.

Desirable as it may seem, the implementation of financial compensation faces important hurdles. We address what we think is the major hurdle: *enforcing such a system*. How does one ensure that the required fine, whatever it is ruled to be, is actually paid by a violating country? While an injured country can implement retaliatory tariffs without requiring any cooperation from a violating country, such is not the case for fines. Ultimately, a violating country has to agree to pay the fine and it will only do so when it is in its best interest since there exists no supra-national authority that can enforce the payment of the fine.[5] This enforcement problem with financial compensation is clearly reflected in the current DSU — it allows for compensation but does not specify the form it must take. Article 22.2 of the DSU states that the compensation must be mutually agreed upon and if it is not, an injured country can apply for retaliation. The only case that we know of where a dispute resulted in monetary compensation was when the US was found guilty of non-payment of royalties by US firms to the EU. This shows that while financial compensation is possible under the DSU, it simply has not been agreed to in most trade disputes that have come before the WTO.[6]

An important objective of this paper is to analyze the effectiveness of alternative dispute remedies in maintaining relatively low trade barriers. We also analyze the effectiveness of the different systems from the perspective of compensating injured countries. In so doing, we argue that one needs to account not only for how a remedy is able to enforce cooperation but also *how the remedy itself can be enforced*. For fines to succeed in enforcing low tariffs and providing compensation, it is crucial that they be backed by a supporting instrument that is not controlled by a violating country. Retaliatory tariffs are the obvious choice for such a *supporting* instrument. However, we show that a system where retaliatory tariffs are used to support the payment of fines yields no more cooperation than one that uses tariffs alone to retaliate against violations.

The equivalence of fines and tariff retaliation in terms of enforcement suggests that both mechanisms yield the same payoffs. However, we show that this is only true if there are no deviations from cooperation. When such deviations occur, and they clearly do in practice, we show that fines supported by tariffs have an advantage over tariff retaliation as a primary remedy. Namely, the payoff to an injured country is higher under fines even though the cost of the penalty for a violating country is unchanged. Thus we show that switching to fines generates a Pareto improvement in the presence of shocks that result in disputes. The underlying rationale for this result is that tariffs are an inefficient form of compensation: the welfare gain they generate for an injured country with market power is always less than the welfare cost they impose on the country that commits the original violation.[7]

Given the aforementioned result regarding the equivalence of fines and tariffs from an enforcement perspective, it is important to ask whether alternative financial mechanisms can help sustain greater cooperation. To this end, we ask whether international cooperation can be sustained by a system where countries exchange bonds of a given amount, with the understanding that a country's bond will be forfeited in case it commits a trade violation. We find that the exchange of bonds between symmetric countries does not improve enforcement relative to a system based solely on retaliatory tariffs. This is because a deviating country has no incentive to return the other country's bond and the extra benefit of deviating on bonds is exactly offset by the cost of losing one's own bond.

Our paper is related to the literature on the enforcement of trade agreements, early contributions to which are reviewed in Staiger (1995). Since then there have been several important contributions and here we briefly note some that are particularly relevant for our paper. Park (2000) studies cooperation between a large and a small country (which has no market power) and shows, among other things, that trade agreements where the small country can make direct transfers can enforce lower tariffs. This is because the threat of terminating the transfer payment gives the small country more leverage than a tariff retaliation. The "purchase" of market access to a large country by a small one is an interesting and relevant result when this transfer is understood

4 For example, Bronckers and Van Den Broek have argued strongly in favor of financial compensation as a means of settling trade disputes (see editorial in the Financial Times, 06/24/04 and Bronckers and Van Den Broek, 2005).

5 Another hurdle might be an informational one: determining the financial loss incurred by an exporter. However, a similar issue occurs under the current tariff retaliation system. For more recent discussions by legal scholars on improvements of the WTO's DSU and use of monetary compensation see Shaffer (2003) and Hudec (2002).

6 However, monetary fines have recently been introduced by the US in its preferential trade agreements with Singapore, Chile, the central American countries, and Australia. More specifically, in these agreements, monetary fines are typically a preferred form of compensation when there is a violation related to the trade or intellectual property right provisions.

7 In a different context, Hoekman and Saggi (2007) argue that since most developing countries lack the institutional capacity for fighting foreign export cartels via antitrust enforcement, developed countries ought to ban such cartels in return for tariff concessions or some monetary compensation. Cartelization creates an inefficiency much like the use of a tariff by a large country in that the loss suffered by the injured party exceeds the gain of the other party.

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