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## WTO News

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### Comment

#### GATT and GATS Unlikely to Converge

The GATT and the GATS follow two fundamentally different approaches: whereas in the area of trade in goods, the GATT focuses on the liberalisation of cross-border transactions and does not give particular attention to investment rules, the GATS (with its current schedules of commitments) may be regarded as an agreement on the liberalisation of foreign direct investment in the services sector. Although, in principle, the GATS also covers cross-border trade in services as well as the temporary movement of natural persons supplying services, the relevant commitments in the schedules are essentially about entry into the market through foreign subsidiaries.

The difference in the focus of the GATS and the GATT is often seen as a temporary imbalance arising from such a recent agreement. Accordingly, observers argue that the Doha Round of multilateral trade negotiations should aim to bring a more appropriate balance of commitments in the GATS across sectors and across modes of supply. In the goods sector, there are similar calls for the inclusion of investment rules. However, I maintain in this article that these demands for a convergence of the GATT and the GATS are unrealistic. The diverging orientations of the GATT and the GATS mirror differences with regard to the nature of economies of scale and regulatory practices between these sectors. Accordingly, I do not expect the Doha Round to fundamentally change this imbalance.

#### Economies of Scale and Pressure for Liberalisation

Governments agree to trade liberalisation as long as this yields political benefits. They draw support from firms and business associations which wish to exploit their comparative advantage on world markets. The pressure for liberalisation is particularly strong if home markets are not big enough to allow firms to fully reap the benefits of specialisation and larger size. Such economies of scale may originate from high investments into research and development, or from a better utilisation of larger production plants. Economies of scale have strongly determined the diverging liberalisation strategies of the GATT and the GATS.

In the goods sector, economies of scale stem essentially from the production process. Centralised production of goods with subsequent international distribution is therefore a dominant strategy. This finding is not in contrast to the observation that an increasing portion of international trade is intra-firm trade. In these cases, inputs are produced centrally and traded internationally between different parts of a firm. As a consequence, direct cross-border trade must flow as freely as possible in order to allow firms to fully reap such economies of scale.

In the services sector, economies of scale are often of a different nature. They usually arise from the production of knowledge or, as in the case of the financial services sector, the financial stability of the service supplier. Such economies of scale can easily be created centrally and distributed to decentralised service suppliers without cross-border sales contracts. The supply of the service as such – the conclusion of a credit or insurance contract, the payment transaction or the provision of consulting services – does not yield important economies of scale. A local subsidiary supplying the service locally and relying on centrally available information is therefore in many significant service industries the most efficient form of organisation for the exploitation of advantages specific to the firm.

Given the different nature of economies of scale in the goods and services sectors, it may reasonably be expected that the pressure for further liberalisation will be directed towards direct cross-border trade in the case of goods and better conditions for the establishment of foreign subsidiaries in the case of services.

### **Domestic Regulation and Trade**

Differences in the need for domestic regulation of the two sectors are another reason for the diverging approaches to liberalisation in the GATT and the GATS. Governments have strong incentives to regulate to a high degree the production and commercialisation of goods and services. The protection of health, consumers, industrial safety or protection from deceptive business practice are only a few of the considerations, and they enjoy wide political support.

With regard to trade in goods, quality and safety regulations mainly refer to characteristics of the products themselves. They can therefore be enforced quite easily in cross-border trade, for instance by certification as to the conformity of a product with national technical regulations or norms. In the case of services, by contrast, it is often not the service as such but the service supplier who is regulated and has to fulfil certain prerequisites. Training requirements or financial stability requirements are examples. Accordingly, regulatory bodies prefer to have direct control over the foreign service supplier and such control is exercised more effectively if foreign suppliers establish local subsidiaries. Governments will therefore prefer foreign direct investment to direct cross border trade as the market-entry mode for services.

### **The Two Agreements Unlikely to Converge**

The preceding arguments suggest that the diverging orientations of the GATT and the GATS are an answer from governments to the priorities voiced by various stakeholders, and not just an incidental consequence of the time-lag between the early liberalisation of trade in goods and the relatively recent liberalisation of trade in services. Accordingly, I do not expect the Doha Round to bring any fundamental changes with regard to these two different approaches.

Preliminary evidence in support of this conclusion is readily available. For instance, WTO members were unable to agree on a mandate for negotiations on investment rules in the GATT prior to the Doha Ministerial Conference. The task of preparing a widely acceptable mandate for negotiations for the 2003 Ministerial Conference in Mexico proves difficult, to say the least. One may reasonably expect that negotiations with regard to trade in goods will primarily be limited to a further reduction of trade barriers in direct cross-border trade.

With regard to trade in services, there are indications to the contrary. According to informal statements of negotiators, Doha Round negotiations will concentrate on liberalisation with regard to the establishment of foreign subsidiaries, whereas there is only little momentum for the liberalisation of direct cross-border services trade. This general orientation is not only visible in negotiations between the existing members of the WTO, but is also apparent in negotiations on the accession of new members, as China's entry into the WTO illustrates. Local subsidiaries of foreign financial service suppliers will have the right to provide basically a full range of services to corporate and private clients after a five year transition period. But China has not made any commitments with regard to direct cross-border supply of financial services (and was rarely asked to do so). I assume that negotiations with Russia will follow a similar pattern.

### **Difficulties for E-Commerce**

As long as trade in goods and trade in services can be clearly separated, the divergent approaches to liberalisation in the GATT and the GATS should not create any major co-ordination problems. These will arise, however, if close substitutes are subject to differential treatment according to the agreement by which they are covered. There is a real danger that the fragmentation of the WTO system would then create unnecessary distortions.

Such a danger exists for those services that can increasingly be made available through the Internet. Here, direct cross-border distribution has major economic advantages. However, such transactions have so far not been able to benefit from corresponding commitments in the GATS. Similar uncertainties exist with regard to the exercise of regulatory authority by the importing country. Accordingly, more co-ordination is needed inside the GATS.

However, there is also a need for more co-ordination between the GATT and the GATS – for example in the case of services that can be provided digitally and which are, at the same time, close substitutes to traditional goods. Examples include movies or musical recording. They can be distributed as hard copy (goods) or in electronic form (services). If such products are subject to different agreements and different conditions for market access according to the mode of provision, artificial distortions result. If a larger part of trade volumes should become digitally tradeable in the future, new solutions will have to be found.

To sum up, there is a need for stronger co-ordination between the approaches of the GATT and the GATS. At the same time, however, political and economic considerations do not suggest that the two agreements are likely to converge in the near future. Even after the conclusion of the Doha Round, the GATT is likely to remain basically a trade agreement, whereas the GATS will continue to be essentially an agreement on foreign direct investment in the services sector. This can create frictions for future trade relations. *Heinz Hauser*



## Dispute Settlement

### Retaliation in the FSC Case: Pushing It Too Far?

The United States have recently gone through an unpleasant time at the WTO. On 30 August 2002, the WTO Arbitrators published their decision on the appropriate level of suspension of concessions in the Foreign Sales Corporations (FSC) case (WT/DS108). Accordingly, the EU would have the right to suspend trade concessions as claimed amounting to over 4 bn USD against the United States. The ruling comes after the U.S. failed to implement the recommendations of the DSB in this case. On 16 September, the panel report found in the case „Byrd Amendment“ (WT/DS217, WT/DS234) that the U.S. practice to pay liquidated antidumping duties to U.S. enterprises was in breach of GATT rules. This complaint had been brought to the WTO by eleven countries (counting the EU as one).

Taking further into account that the U.S. are likely to lose the dispute on their steel safeguards, the question remains how the weakened position of the United States will affect their behaviour in the WTO: Will the U.S. fulfil their obligations and implement the recommendations issued by the DSB, will they accept the retaliatory measures for non-implementation, or will they turn their back on the WTO? In how far will the massive retaliatory measures in the FSC case further complicate the already difficult relationship with the EU? Given that prohibitive duties may be imposed on up to 2% of all US exports to Europe, there is finally enough reason to question the appropriateness of the current regime for preventing or sanctioning violations of WTO law.

#### The FSC Case

The WTO has been dealing with the FSC case for a long time (see also WTO-News No. 2 dated December 2000 – only in German). The dispute concerns specific U.S. tax breaks for profits from U.S. exports that are channelled through so-called Foreign Sales Corporations (FSCs). The panel and the Appellate Body both found in Spring 2000 after a complaint from the EU that these rules constitute forbidden export subsidies that are inconsistent with WTO law. The U.S. government subsequently tried to implement the DSB recommendations through the FSC Repeal and Extraterritorial Income Exclusion Act of 2000. As this was more of a cosmetic change rather than the revocation of the export subsidy, the EU soon contested the legality of the new legislation. In the light of the sequencing issue in the application of Art. 21 and Art. 22 of the WTO Dispute

Settlement Understanding (DSU), the EU and the U.S. negotiated in September 2000 an understanding which defined procedures for the follow-up of the case. The parties agreed that a compliance panel would first review the conformity of the implementation measure with WTO law. Both parties could then appeal the panel report. If the WTO were to find that the U.S. implementation measure was not in conformity with WTO law, the U.S. could ask for arbitration on the appropriateness of the countermeasures requested by the EU.

President Clinton had hardly signed the implementation act in November 2000 when the EU Commission requested consultations under Art. 21.5 DSU and the suspension of concessions worth USD 4.043 bn. The U.S. objected to the level of retaliation and the issue was referred to arbitration which, however, remained suspended until the compliance panel procedure was concluded. On 29 January 2002, the reports of the compliance panel and the Appellate Body were adopted. It was found that the new regime still constituted a violation of Art. 3.1(a) and Art. 4.7 of the Agreement on Subsidies and Countervailing Measures, Art. 8 and 10 of the Agreement on Agriculture and Art. III.4 GATT. With this decision, the arbitration procedure was reactivated. The arbitrators concluded their work on 30 August 2002 by confirming the full amount of countermeasures requested by the EU.

Meanwhile, on 11 July 2002, a new bill was introduced into the U.S. House of Representatives (H.R. 5095: American Competitiveness and Corporate Accountability Act of 2002). Through this new legislation, export-related tax benefits are to be replaced with other tax benefits on income from foreign sources. However, the proposal faces massive resistance as exporters who had been the beneficiaries of the old legislation would lose, while U.S. corporations conducting their overseas business through foreign direct investment would win. Accordingly, pressure groups and political parties are torn over the proposal. As elections are ahead and the bill would also need Senate approval, one should not expect the issue to be resolved soon.

In the meantime, the EU initiated a public consultation on the retaliatory measures planned. A list with the tariff codes of numerous U.S. products from the agricultural and industrial sectors has been published (Official Journal C 217 of 13. September 2002). Punitive duties of up to 100% ad valorem are to be levied on these products. In order to minimise the damage to its own industries, the EU has listed only those products where less than 20% of EU imports are of U.S. origin. Interested parties in the EU are being called upon to comment on the proposals within 60 days.

#### Retaliation: A Questionable Instrument

The possible countermeasures in the FSC case will bring a new dimension to retaliation. Compared with the potential volume of USD 4.043 bn in the FSC case, countermeasures in the Bananas Case (USD 191.4 mn) or the Hormones Case (USD 116.8 mn) were fairly modest. Given recent

annual imports of U.S. origin amounting to USD 200 bn into the EU, prohibitive duties could be levied on roughly 2% of all EU imports of U.S. origin. In the light of these dimensions, it is understandable that U.S. Trade Representative Robert Zoellick likened the case to a nuclear bomb in trade. The economically damaging punitive tariffs could have a sizeable chilling effect on transatlantic trade relations.

Under such circumstances, the general suitability of retaliation as a remedy against non-compliance should not be left unquestioned. On the one hand, the countermeasures harm not only exporters in the country subject to retaliation, even though these exporters are normally not responsible for their government's trade policy sins. On the other hand, the measures also harm consumers and buyers of intermediate goods or inputs in the retaliating country. Moreover, the current systems may also unfold undesirable political effects: Countries which are called upon to implement recommendations of the DSB might rather look for counter-complaints in order to build up their own retaliatory potential instead of doing their homework on implementation. There are signs, for instance, that the whole FSC dispute was more than anything else a EU reaction to its having lost the Bananas and Hormones Cases.

Accordingly, the suspension of concessions is all but an ideal instrument. The question arises whether alternative instruments for the enforcement of WTO law would be available. One possible approach would consist of a multi-lateral agreement on the direct application of WTO law in national legal systems. Indeed, some observers have been proposing such reforms for a long time. WTO law would then have to be applied by national courts. On the one hand, this would make national enforcement mechanisms available to WTO law. On the other hand, some of the political pressure would be taken off the WTO. A possible extension of such a model could be the establishment of a preliminary rulings procedure known from EU law which could ensure the uniform interpretation of WTO law in all WTO member states. While such proposals may be theoretically tempting, current political trends, however, seem to further rather a strengthening of national sovereignty. For the time being, such fundamental systemic changes appear to be quite unrealistic.

### **WTO Dispute Settlement Loses Its Initial Splendour**

Returning to the FSC Dispute, it looks as if the United States will not implement the DSB recommendations in a timely manner, given the current economic and political environment. The European Union, in turn, is likely to use its newly won negotiatory power vis-à-vis the United States. After all, the Europeans themselves had to face some delicate U.S. complaints shortly after the inception of the new dispute settlement system a few years ago. The path towards further escalation therefore seems unavoidable. Will the U.S. build their own "trade nuclear bomb" such as a complaint against restrictive EU policies with regard to genetically modified organisms (GMOs)? Or are there already negotiations taking place behind closed doors,

where the Europeans ask the Americans to abandon a similar counter-complaint in exchange for not retaliating in the FSC dispute? Maybe a credit for not retaliating could also be brought into the Doha Round of multilateral trade negotiations where it might be netted with U.S. claims.

Whatever shape the final solution will assume, the narrow framework provided in the consideration of individual cases by the dispute settlement organs will not provide sufficient leeway in order to resolve this issue. In general, the dispute settlement system is under considerable political pressure, resulting from the incapability of WTO members to develop the WTO system between the large rounds of multilateral trade negotiations. On the one hand, politically delicate disputes continue to accumulate. On the other, the obligation to interpret treaty provisions that have sometimes deliberately been left vague is an unrewarding task. While the old GATT was equipped with a political protector valve – namely the consensus requirement for the adoption of reports – the quasi-automatic adoption of reports in the new WTO is creating political tensions. The increasing criticism of the work of the panels and the Appellate Body is a symptom of these tensions.

### **Back to Diplomacy?**

For the dispute at hand, the actors are likely to have to look for a political solution, possibly based on a compromise which circumvents WTO discipline to a certain extent. In this case, however, one would have to admit that the WTO as an organisation of sovereign states is not yet mature for the strongly rule-oriented design of the dispute settlement system with its focus on litigation. After the political mechanisms have taken a back seat in recent years following the Uruguay Round, a return to more diplomacy might first bring about some dilution of WTO discipline. Although that is economically undesirable, insistence on the strict compliance with the rules in each and every instance might also lead to a dead end if economically and politically powerful members were to gradually withdraw from the WTO system. In this case, the more power-oriented concepts of unilateralism, bilateralism or regionalism would dominate international trade relations. That would surely not be beneficial to an open world economy. *Thomas A. Zimmermann*

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