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# Value Chains and WTO Disputes

Compliance at the dispute  
settlement mechanism

Aydin Baris Yildirim

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*Dedicated to  
Annem ve Babam'a*

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## CHAPTER 1

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# Introduction

**Abstract** In an era where economic nationalist policies have been threatening the global trade order, the ability of the World Trade Organization (WTO) to maintain a liberal trade regime has come under intense scrutiny. Considering the decline of the WTO as a forum for negotiated trade liberalization, epitomized by the long-lasting impasse of the Doha Round, the importance of the WTO's judicial arm as a tool to maintaining a liberal trade regime has increased. In this backdrop, this chapter offers an overview of a novel theory that explains why and when governments are more likely to cooperate at the WTO dispute settlement and faster in complying with the rulings of the WTO panels. At the heart of this theory lies internationalization of production and cross-border value chains that shape the preferences domestic actors in trade policymaking—i.e., firms and sectors. I start by laying out the puzzle addressed in the book, give the readers an overview of how value chains pose a systemic counter force to the protectionist interests, and conclude by providing an outline of the book.

**Keywords** World Trade Organization · Dispute settlement · Compliance · Value chains

## 1.1 COOPERATION AND DISCORD IN THE INTERNATIONAL TRADE REGIME

In an era where economic populism has been threatening the global trade order, sustaining multilateral cooperation is becoming increasingly difficult. From the unilateral protectionist measures adopted by the Trump administration in the United States (US) to the British exit from the European Union (EU) that has fueled the mobilization of domestic isolationist interests, world trade regime is witnessing a number of challenges to maintaining previously made multilateral trade commitments. This book aims to shed light upon the conditions under which such challenges can be met and examine political-economic factors that explain World Trade Organization (WTO) members' behavior at the judicial arm of the WTO—i.e., the dispute settlement mechanism (DSM).

The decline of the WTO as a forum for negotiated trade liberalization, epitomized by the long-lasting impasse of the Doha Round, has increased the importance of the WTO's judicial arm as a tool to maintaining a liberal trade regime. Even in the face of blatant attacks on the legitimacy and the functioning of the WTO at the world stage, WTO Members increasingly rely on the DSM to resolve trade-related grievances—the number of disputes launched in 2017 and 2018 by the US, the EU, and other small and middle-sized economies is indicative of this trend.

Yet, as the need to sustain an open world economy is becoming more pressing, we know surprisingly little about WTO Members' behavior in response to international litigation. When are states more cooperative at the WTO? If they spend years drafting, ratifying, and implementing multilateral trade agreements, why do they sometimes refuse to abide by them? The literature on the institutional foundations of international cooperation suggests that the existence of mechanisms for the credible enforcement of agreed-upon rules is key to overcoming problems of cooperation that are typical of international trade relations (Keohane 1984; Martin 1992). A quasi-judicialized system of enforcement, such as the WTO DSM, should therefore be capable of performing the twofold function of preventing first and second-order compliance problems: creating disincentives for policies incompatible with WTO rules being adopted in the first place, and compelling members to bring their policies back into compliance with WTO rules whenever their wrongdoing is ascertained by the adjudicative body (Von Stein 2012).

However, we observe quite often that even in the face of authorized retaliation and direct financial penalties, WTO Members refuse to meet the demands of their trade partners. In other instances, the same WTO Members remarkably comply with their commitments in a swift manner without undue delays.

Consider the following examples: While the EU resisted to comply with the decision of the WTO panels in its long-standing dispute regarding imports of bananas from the African, Caribbean, and Pacific regions for some 15 years, a hotly debated dispute on imports of solar panels from China was resolved in less than two years (Chen 2015). It cost the EU approximately €200 million to keep the trade restrictions of bananas in place for so long and damaged its reputation as a law abiding WTO Member, creating a number of diplomatic tensions (Patterson 2001).<sup>1</sup> Similarly, in response to a dispute launched in 2001, the US resisted to meet the demands of its long time trade partner—Canada—regarding exports of softwood lumber for almost 5 years, despite authorized retaliation by the WTO. It costs Americans millions in legal fees, up to \$200 million in retaliatory sanctions, and created a significant source of political tension with its Canadian neighbors (Lawrence 2007). In contrast, the US complied with the adverse panel ruling of the WTO regarding imports of steel products in 2002 in a matter of few months after the panel's decision was adopted, avoiding prolonged disputes and the risk of further economic and political damage.<sup>2</sup>

WTO Members' decisions to prolong disputes or quickly comply with the rulings of the dispute settlement panels have significant economic consequences. When raising protectionist trade barriers or eliminating existing trade restrictions, the distributive impact of such decisions empowers certain groups while hindering the political clout of others, both domestically and internationally. Following the example given above, when the US government decided to raise trade barriers in the steel sector in 2004, in a matter of months the US steel producers had a sharp surge in demand and almost doubled their revenue (Read 2005). In contrast,

<sup>1</sup>For a brief overview, see Patrick Barkham, "Banana Wars Explained," *The Guardian*, March 5, 1999. Accessed on February 12, 2017 via: <https://www.theguardian.com/world/1999/mar/05/eu.wto3>. See also Wall Street Journal, "WTO Allows Ecuador to Impose Sanctions in EU Banana Dispute," March 19, 2000. Accessed on February 12, 2017 via: <https://www.wsj.com/articles/SB95345909977897928>.

<sup>2</sup>See, *United States—Definitive Safeguard Measures on Imports of Certain Steel Products*.

consumers of steel such as automotive parts makers were suddenly cut off from their overseas supply lines and started to buy domestic steel at a higher price, increasing their cost of production some 20% (Francois and Baughman 2001). In the meantime, exporters of steel to the US from Europe or elsewhere lost an important part of their revenue stream.

This transfer of economic resources also has far-reaching political consequences. Domestically, empowered groups will find it easier to mobilize with their expanded resources, potentially shifting the domestic balance of interests in their favor. Thus, WTO Members' behavior at the WTO DSM would have direct implications for domestic societal interests. However, refusing to uphold international rules at the WTO DSM may have severe systematic repercussions on a global scale. One of the current debates on international trade raises the question of whether or not the current US administration under President Trump continues its zealously protectionist behavior at the expense of US commitments at the WTO.<sup>3</sup> Indeed, policies that involve raising WTO-incompatible trade barriers or resisting to comply with the rulings of the panels would have far-reaching consequences for the global trade governance regime. For one, raising trade barriers can continue to invoke retaliatory threats from US trade partners, inciting a spiral of retaliation. Secondly, and more importantly, refusing to cooperate in the WTO DSM might heavily undermine the legitimacy of the WTO itself; the institution may be questioned due to its inability to deter opportunism, which would be regrettable since it was successful in preventing protectionism during the 2007–2008 financial crisis (Baccini and Kim 2012).

Examining the conditions under which WTO Members are more likely to comply with dispute settlement decisions is also theoretically interesting. Understanding how economic resources are distributed among societal groups due to international trade policies can shed light on how these groups may yield political influence with their resources. This in turn will help examine further developments in international political economy (IPE). Moreover, analyzing the conditions of sustained cooperation versus

<sup>3</sup>See, among others, John Plender, "Trump Trade Blind to Global Cost of Protectionism," *Financial Times*, 31 January 2017. Accessed on March 2, 2017 via: <https://www.ft.com/content/2bee373a-c786-11e6-893c-082c54a7f539>. Katie Allen, "Trump's Economic Policies: Protectionism, Low Taxes and Coal Mines," *The Guardian*, November 9, 2016. Accessed on March 2, 2017 via: <https://www.theguardian.com/us-news/2016/nov/09/trumps-economic-policies-protectionism-low-taxes-and-coal-mines>.

discord in international trade governance can give us a general clue about cooperation in international relations.

Accordingly, this book aims to answer the following research question: *under what conditions do WTO Members swiftly comply with adverse WTO panel rulings?*

In order to account for such variation in WTO Member behavior, a broad examination of trade policymaking is needed, one that takes into account societal trade-related interests as well as the growing internationalization of production. While the former has received significant attention in the field of politics and international relations (IR), the latter needs much more attention. Scholars have extensively demonstrated that the demands of mobilized domestic groups and their respective power are the primary force that shapes state policies (e.g., Milner 1987; Moravcsik 1997; Goldstein and Martin 2000; Mansfield and Milner 2017). According to this conventional view, policymakers are bound to the demands of their domestic constituencies and act by steering a course between potentially conflicting interests. However, even though the impact of domestic actors on economic policies has been explored in detail, explaining their impact on WTO Member governments' responses to litigation has been limited at best.

In order to account for the variation in the time it takes WTO Members to comply with panel rulings, this book proposes a novel theoretical argument that focuses on the importance of internationalization of production on trade policymaking. It highlights how varying degrees of integration into networks of production shapes the preferences of domestic political-economic actors—i.e., firms and sectors—which ultimately shapes the behavior of WTO Member governments in response to litigation.

Over the last few decades, a growing trend in the field of IPE have brought about a rich and growing scholarly work that focuses on the complex, interconnected, and yet geographically dispersed patterns of trade and production, referred broadly as “global value chains” (e.g., Baldwin 2012; Elms and Low 2013) or “global production networks” (e.g., Levy 2008). This nascent literature has highlighted a particular type of internationalization that focuses on the activity of firms that increasingly engage in productions across different countries where they produce various parts and components before delivering a final product or service. These changes in patterns of trade, production, and distribution activities of firms—collectively referred as “integration into value chains”



in this study—have systematically transformed the structure of world trade, where a state’s comparative advantage—namely, productivity—and competitiveness increasingly lie in its degree of integration into these chains of production. Illustratively, the United Nations Conference in Trade and Development (UNCTAD) recently reported that almost 60% of world trade now consists of trade in intermediate goods and services (UNCTAD 2013) while it is estimated that more than 80% of merchandise exports and imports of pivotal international economic players now takes place within networks of production and distribution (e.g., Bernard et al. 2009). In consequence, firms and sectors that are active in value chains now engage in value-added trade across borders, and rely extensively on foreign inputs for their productions, creating an additional demand for trade liberalization.

Current developments in US trade policy reveals the importance of internationalization in triggering the political mobilization of integrated firms and their sector associations. Although at first sight it might be perceived that firms’ integration could not stop the protectionist policies helmed by the Trump administration, firms and sectors active along supply chains have been mobilizing with speed and fiercely opposing the administration’s protectionist policies. Take the US steel sector for instance. In response to the recent imposition of retaliatory tariffs from several US trade partners in the steel and aluminum production sector, highly integrated US steel manufacturers and automotive companies, such as NLMK US, the California Steel Industries, and the Alliance of Automotive Manufacturers, protested against the measures and later petitioned to the Department of Commerce in order to be exempt from the duties raised.<sup>4</sup> Moreover, American Institute for International Steel resorted to domestic litigation and filed an action in the US Court of International Trade, challenging the constitutionality of the Trump administration’s use of Section 232—i.e., the section of the law allegedly allows the president to enact tariff duties.<sup>5</sup>

<sup>4</sup>See for instance, Richard Lardner, “Rising Backlash as US Firms Seek Trump’s Steel Tariff Waiver,” *The Associated Press*. Accessed on 22 August 2018 via: <https://globalnews.ca/news/4359349/rising-backlash-as-us-firms-seek-trumps-steel-tariff-waiver/>.

<sup>5</sup>See for instance, Shawn Donnan and Vladimir Waldemir, “Industry Backlash to Trump Tariffs Grows with Legal Challenge,” *Financial Times*. Accessed on 10 September 2018 via: <https://www.ft.com/content/7e35b986-7a20-11e8-bc55-50daf11b720d>.

Similarly, import-dependent firms have shown similar agility regarding their political mobilization in response to threats to their operations. On December 2016, President Trump announced his plan to introduce a so-called border adjustment tax that would have increased the cost of exports to the US by up to 20% across the board on many goods and services (Bown 2017). Following his announcement, many American firms that heavily depend on imports immediately started to mobilize against it and formed a coalition to stop it from going forward.<sup>6</sup> Chief Executive Officers (CEO's) of Walmart, Target, Best Buy, GAP, among others, have called on the US administration to scrap the tax, claiming that it would wipe their profits out, as opposed to import-competing groups who expressed their clear support.<sup>7</sup> While it is too early to say how successful these attempts will be, one thing is clear, firms and sectors integrated into value chains—and rely on foreign imports—(re)act swiftly to pursue their trade policy preferences—a point I return to in the conclusion.

Internationalization of production has far-reaching implications for the politics of WTO dispute settlement. In a world increasingly characterized by international value chains, WTO Members now face additional pressure from domestic actors (i.e., firms and sectors integrated into value chains) to keep their trade liberalization commitments in place. The political activity of these actors essentially increases the domestic demand for trade liberalization, which in turn increases policymakers' incentives to resist the demands of protectionist interests. In line with this logic, I posit that the time until WTO Members comply with the rulings of the WTO panel is much shorter when a dispute affects firms active in sectors that are integrated into value chains. In such disputes, these actors are triggered to mobilize and seek to remove these barriers that restrict their cross-border trade. Disruption to their cross-border trade gives them an incentive to

<sup>6</sup>Corinne Ruff, "Wal-Mart, Target, NRF Lead Retail Industry Coalition to Fight Border Tax," *Retail Dive*, February 2, 2017. Accessed on March 10, 2017 via: <http://www.retaildive.com/news/wal-mart-target-nrf-lead-retail-industry-coalition-to-fight-border-tax/435359/>.

<sup>7</sup>Ylan Mui, "Trump Gets an Earful About a Tax That Retailers Call 'Risky and Unproven'," *CNBC News*, February 15, 2017. Accessed on March 10, 2017 via: <http://www.cnn.com/2017/02/15/border-adjustment-retailers-tell-trump-about-risky-and-unproven-tax.html>. Lucinda Shen, "These 21 Companies Back the GOP's Proposed Border Adjustment Tax," *Fortune Finance*, February 13, 2017. Accessed on April 1, 2017 via: <http://fortune.com/2017/02/13/donald-trump-border-adjustment-tax-support/>.