How Important can the Non-Violation Clause be for the GATT/WTO?

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GATT Article XXIII:1

If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of

(a) the failure of another contracting party to carry out its obligations under this Agreement, or

(b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or

(c) the existence of any other situation,

the contracting party may [have recourse to the dispute resolution process]...
Incomplete contracts and the non-violation clause:

- Intriguing attempt to address contractual incompleteness

Shallow integration and the non-violation clause (ToT Theory):

- Globally efficient policies achievable with negotiations over tariffs and "market access preservation rule" to handle domestic policies
- Nash domestic policies efficient; market access preservation rule prevents deflection of ToT-manipulation to domestic policies
- Non-violation clause looks a lot like market access preservation rule
Observed performance of non-violation claims in GATT/WTO disputes seems weak relative to violation claims.

- Rulings on non-violation claims are rare compared to violation claims: \( \leq 8\% \) of disputes with rulings.

- Success of non-violation claims is low compared to violation claims: 35\% versus 73\% success rate.

Despite this, non-violation claims made in 20\% of disputes with rulings.
Introduction: Questions

- Can a model account for the weak performance measures of non-violation claims?

- What is implied about the (on- and off-) equilibrium impacts of the non-violation clause on the joint welfare of GATT/WTO members?

- Answer requires a model that predicts disputes in equilibrium
  - Introduce non-violation claims into Maggi and Staiger (2011); identify conditions under which model delivers broad features described above
  - Use model under these conditions to consider nature and potential importance of role that non-violation claims can play in GATT/WTO
Model consistent with the broad stylized facts when:

- domestic measures a poor second to tariffs for ToT manipulation
- efficiency of GATT/WTO compensation mechanism in disputes (tariff retaliation) is low
- accuracy of GATT/WTO court (DSB) is high

Under these conditions, non-violation clause can play important role:

- functions mostly off-equilibrium to reroute policy interventions into forms that are explicitly addressed by the GATT/WTO contract
- prevents circumvention of negotiated market access commitments
- in line with the role emphasized by economists and legal scholars and envisioned by the drafters of GATT
Model Overview

- Maggi and Staiger (2011): importing gov chooses trade policy $\tau \in \{FT, P\}$
  - Ex ante, importing and exporting govs can write an incomplete contract, set up DSB and define its mandate
  - Ex post, uncertainty resolved, importing gov makes trade policy choice and exporting gov decides whether to initiate dispute, which if initiated is resolved by DSB according to mandate and a noisy signal

- We extend this model in two ways
  - In addition to $\tau \in \{FT, P\}$, we allow importing gov to also make a domestic regulatory choice $r \in \{FT, R\}$
    - but while $\tau$ is contractible, $r$ is non-contractible
  - In addition to violation claim (against $\tau$), we introduce possibility of bringing a non-violation claim (against $r$ or $\tau$)
    - and while violation claim a “property rule,” non-violation claim a “liability rule”
Economic Environment

- A single industry; importing gov chooses $\tau \in \{FT, P\}$ and $r \in \{FT, R\}$ to maximize $\omega(\tau, r; s)$, $s \equiv (s_1, s_2, ..., s_N)$ a state vector

- Each state variable represents a binary event, such as “there is/is not an import surge” or “the product does/does not contain asbestos”

- The exporting gov is passive in this industry; its payoff is $\omega^*(\tau, r; s)$

- Assume never efficient/unilaterally optimal for Home to protect and regulate simultaneously, so 3 relevant policy settings:
  - $\mathcal{FT} \equiv \{\tau = FT, r = FT\}$
  - $\mathcal{P} \equiv \{\tau = P, r = FT\}$
  - $\mathcal{R} \equiv \{\tau = FT, r = R\}$
Economic Environment

- Importing gov’s gain from \( P \): \( \gamma^P(s) \equiv \omega(P; s) - \omega(FT; s) > 0 \)
- Importing gov’s gain from \( R \): \( \gamma^R(s) \equiv \omega(R; s) - \omega(FT; s) > 0 \)
- Exporting gov’s loss from \( P \) or \( R \): \( \gamma^*(s) \equiv \omega^*(FT; s) - \omega^*(P; s) = \omega^*(FT; s) - \omega^*(R; s) > 0 \) for all \( s \)
  - Joint (positive or negative) gain from \( P \): \( \Gamma^P(s) \equiv \gamma^P(s) - \gamma^*(s) \)
  - Joint (positive or negative) gain from \( R \): \( \Gamma^R(s) \equiv \gamma^R(s) - \gamma^*(s) \)

- First best policy:
  \[
  \sigma^{FT} \equiv \{ s \mid \max[\Gamma^P(s), \Gamma^R(s)] \leq 0 \}
  \]
  \[
  \sigma^P \equiv \{ s \mid \Gamma^P(s) > \max[0, \Gamma^R(s)] \}
  \]
  \[
  \sigma^R \equiv \{ s \mid \Gamma^R(s) > \max[0, \Gamma^P(s)] \}
  \]
Realized state $s$ observed by govs and DSB, but $s$ too costly to write in a contract

$\Gamma^P$ and $\Gamma^R$ observed by govs but not by DSB, so can’t contract directly over payoffs

Costless to write $\tau$ in a “vague” contract:

- “$\tau = P$ allowed if and only if $\nu$”
- $\nu$ a vague sentence such as “there is serious injury to the domestic industry due to increased imports”
- off-the-shelf language
- ambiguous meaning in some states of the world

Too costly to write $r$ in a vague contract
DSB can be asked to address a *violation complaint* against Home choice of $\tau = P$

- If meaning of vague contract unambiguous, contract enforced (always off equilibrium in this model)
- If meaning of vague contract ambiguous in state $s$, DSB observes an unbiased but noisy signal of $\Gamma^{P}$ and issues “ruling” $\tau^{DSB}$ that max’s expected joint payoff of govs given signal
- DSB ruling $\tau^{DSB}$ automatically enforced in case of violation complaint

DSB can be asked to address a *non-violation complaint* against Home choice of $\tau = P$ or $r = R$

- If non-violation claim against $\tau = P$, then DSB proceeds as above, except only rules on non-violation claim if it has not already ruled affirmatively on a violation claim
- If non-violation claim against $r = R$, then DSB proceeds as above
- But in the case of non-violation complaint, Home has option of implementing DSB ruling or paying damages $b(s)$
Basic Assumptions

- Assumption 1: protection better for ToT manipulation than regulation
  \[ \gamma^R(s) = \theta \cdot \gamma^P(s) \text{ with } \theta \in (0, 1) \text{ for } s \in \sigma^{FT} \]

- Assumption 2: damages set at level of harm to Foreign
  \[ b(s) = \gamma^*(s) \text{ for } s \in \Sigma \]

- Assumption 3: damage payments are inefficient
  \[ b^*(s) \equiv \delta \cdot b(s) \text{ with } \delta \in (0, 1) \text{ for } s \in \Sigma \]

- Probability of “wrong” DSB ruling is \( q \in (0, 1/2) \); per claim cost of dispute to Foreign (claimant) is \( c^* \), to Home (defendant) is \( c \)
Stage 0. The state $s$ is realized

Stage 1. Home chooses $\tau \in \{FT, P\}$ and $r \in \{FT, R\}$

Stage 2. Foreign decides whether to file a V and/or an NV complaint with the DSB

Stage 3. If invoked for a V complaint, the DSB issues a ruling $\tau^{DSB} \in \{FT, P\}$; if invoked for an NV complaint, the DSB issues a ruling $\tau^{DSB} \in \{FT, P\}$ or $r^{DSB} \in \{FT, R\}$; if invoked for a V&NV complaint, the DSB issues a first (V) ruling $\tau^{DSB} \in \{FT, P\}$, and issues a second (NV) ruling $\tau^{DSB} \in \{FT, P\}$ if and only if its first ruling is $\tau^{DSB} = P$

Stage 4. If the DSB is invoked and issues an NV ruling that goes against Home, then Home chooses whether to revert to $FT$ or maintain its policy and pay damages $b$

Stage 5. Payoffs are realized
For $s \in \sigma^R$, Figure 1a summarizes

Note: NVs in $\sigma^R$

- $\implies$ Foreign trying to inefficiently force $\mathcal{FT}$
- NV claim $\implies$ NV ruling, succeeds with probability $q$
- $\therefore$ Paucity of NV rulings $\implies \frac{c^*}{\delta q}$ high relative to $\gamma^*(s)$ for almost all $s \in \sigma^R$; Figure 1a
- Later will need $\frac{c^*}{q}$ low, so small $\delta$ implied
Figure 1a: $s \in \sigma^R$ for fixed $\gamma^P(s)$
Figure 1a: $s \in \sigma^R$ for fixed $\gamma^P(s)$
When the first best policy is protection – Proposition 3

- For \( s \in \sigma^P \), Figure 1b summarizes
- Note: NVs in \( \sigma^P \)
- NV claim alone
  - \( \rightarrow \) Home trying to get away with inefficient \( \mathcal{R} (\Gamma^\mathcal{R}(s) \leq 0) \) or Foreign trying to inefficiently force \( \mathcal{F}\mathcal{T} (\Gamma^\mathcal{R}(s) > 0) \)
  - NV claim alone \( \rightarrow \) NV ruling, succeeds with probability \( (1 - q) \) for \( \Gamma^\mathcal{R}(s) \leq 0 \) and probability \( q \) for \( \Gamma^\mathcal{R}(s) > 0 \)
  - \( \therefore \) Paucity of NV rulings \( \rightarrow \frac{\varepsilon^*}{\delta q} \) high relative to \( \gamma^*(s) \) for almost all \( s \in \sigma^P \): small \( \delta \) implied

- V&NV claim
  - \( \rightarrow \) Foreign trying to inefficiently force \( \mathcal{F}\mathcal{T} \)
  - V&NV claim \( \rightarrow \) NV ruling with probability \( (1 - q) \), succeeds with probability \( q \)
  - But V&NV claim rare in \( \sigma^P \) under small \( \delta \); Figure 1b
Figure 1b: $s \in \sigma^P$ for fixed $\gamma^P(s)$
Figure 1b: $s \in \sigma^P$ for fixed $\gamma^P(s)$
When the first best policy is free trade – Proposition 2

- For \( s \in \sigma^{FT} \), Figure 1c summarizes

- Note: NVs in \( \sigma^{FT} \)
  - \( \implies \) Home trying to get away with inefficient intervention
  - NV claim alone \( \implies \) NV ruling
  - V&NV claim \( \implies \) NV ruling with probability \( q \),
  - NV succeeds with probability \( (1 - q) \)
  - NV rulings in \( \sigma^{FT} \) will be rare if \( \theta \lesssim \frac{q}{2} \) and \( q \) low
  - But NV claims will not be rare in \( \sigma^{FT} \) when \( \frac{c^*}{(1 - q)q} \) low relative to \( \gamma^*(s) \) and \( \frac{c}{qq} \) low relative to \( \gamma^p(s) \) for substantial \( s \in \sigma^{FT} \); Figure 1c
Figure 1c: $s \in \sigma^{FT}$ for $\theta \in (0,1)$
Figure 1c: $s \in \sigma^{FT}$ for $\theta \in (0,1)$
Interpreting the weak performance measures of NV claims

According to the model:

- disputes arise with opportunistic behavior – either the claimant seeks to remove globally efficient policies, or the defendant hopes to get away with globally inefficient intervention
- govs rarely use NV claims opportunistically, because even if successful GATT’s NV remedy of self-help reciprocity would be worth little (low $\delta$)
- govs rarely set domestic policies opportunistically, because those policies typically a poor second to tariffs for ToT manipulation (low $\theta$)
- success of NV claims low compared to V claims, because most NV claims serve as backup to V claims against policies that violate GATT/WTO contract, and with accurate DSB the V claims typically succeed and rulings on these (likely successful) NV claims not observed (low $q$)
Corollary to Proposition 7. For $\delta$, $\theta$ and $q$ sufficiently small, the impact of the non-violation clause on expected joint surplus is strictly positive, and is approximated by

$$\nabla E[\Omega] \cong \sum_{s \in \sigma^F_1} p(s) \cdot [\gamma^P(s) - \gamma^R(s)] + \sum_{s \in \{\sigma^F_1 \cup \sigma^F_2 \cup \sigma^F_3\}} p(s) \cdot \gamma^*(s)$$

Figures 2a-2c

Under these conditions, non-violation clause can play important role:

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Figure 2a: \( S \subseteq \sigma^R \) for fixed \( \gamma^P(s) \)
Figure 2b: $s \in \sigma^P$ for fixed $\gamma^P(s)$
Figure 2c: \( s \in \sigma^{FT} \) for \( \theta \in (0,1) \)