

Commentary on the Appellate Body Report in *EC–Bananas III (Article 21.5)*: waiver-thin, or lock, stock, and metric ton?

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Abstract: At first glance, the Appellate Body Report in *Bananas III (Article 21.5; Second Recourse)* does not seem to be a case for the *Guinness Book*.

The AB upheld most of the Panel's findings, and the EC lost big. This was hardly surprising, given that the contested measure only marginally differed from the measure at issue in the first recourse to a compliance Panel. It is at second sight that this AB Report reveals its interesting facets. We highlight a few remarkable legal and economics aspects, some of a more systemic nature, some offering practical insights: For practitioners, the role of *estoppel* in WTO litigation, the legal effect of Panel suggestions, and the relevance of Uruguay Round Modalities Papers as interpretative tools may be of interest. Readers more concerned with systemic aspects of the WTO may take interest in the economics of tariff quotas, the inherently discriminatory nature of tariff-quota allocation in the WTO, and the relevance of compliance proceedings for the damage calculation under Article 22.6 of the DSU.

1. Introduction

The trade dispute over the European Community's banana importation regime is one of the longest-standing cases in the history of the WTO.¹ The fact-load of this case is mind-boggling, and through the years *Bananas* has left a long trail of panels, arbitrations, and procedural battles. The Appellate Body (AB) Report on the second compliance Panel under Article 21.5 of the Dispute Settlement Understanding (DSU) is the presently last stage in the *Bananas* saga.

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¹ See exemplarily Jackson and Grané (2001).

The AB was summoned by the EC to assess substantial findings made by the compliance Panel under Articles II and XIII of the GATT, as well as a host of procedural issues. Sadly for the researcher charged with commenting on this case (but fortunate for the practitioner), there is little scope for criticism against the findings of the AB. Nevertheless, the compliance proceedings in *Bananas III* offer some interesting general legal and economic aspects, for example on the legal nature of Panel suggestions, the economics of tariff quotas, and the relationship between Article 21.5 Panels and arbitrations under Article 22.6 of the DSU.

This paper proceeds as follows: Section 2 gives a brief overview of the rich factual and legal background of *Bananas III*. In Section 3, we summarize the claims on appeal and the AB's findings, and offer a few observations. Section 4 provides a richer discussion of the legal and economic aspects in connection with the *Bananas III* dispute. Section 5 concludes.

2. Factual background and original compliance Panel findings

In this section of the paper, we present a brief overview of the order of events, cite the relevant documents, and provide a summary of the claims in the Article 21.5 proceedings, as well as of the findings of the Panel Report.

2.1 Order of events²

As a result of the Single European Act of 1993, the European Union (EU) initiated the so-called 'Common Market Organization for Bananas' (CMOB). Important for the case at hand, CMOB was characterized by a preferential zero-tariff quota of 857,700 metric tons (mt), dedicated uniquely to bananas originating in African, Caribbean, and Pacific State (ACP) countries, as well as by a global quota of 2 million mt for bananas imported from either third countries or non-traditional imports from ACP countries (MFN suppliers).³ In-quota MFN tariff rates were 75 €/mt; out-of-quota imports were possible, albeit at a virtually prohibitive rate of 680 €/mt.⁴

The CMOB was contentious from the beginning, with a GATT Panel in 1993 and one in 1994 concluding that it was inconsistent with various GATT rules.⁵ In an effort to address the rulings of the GATT panel, the European Communities (EC) signed the 'Framework Agreement on Bananas' (Bananas Framework Agreement or BFA) in October 1994 with four of the five countries that had initiated the original GATT panel. Among other things, the BFA introduced

² The authors of this text appreciate that the factual situation of the *Bananas* saga is rather convoluted. A timeline of events in chronological order, accompanied by short explanations, is annexed at the end of this paper for the reader's convenience.

³ The preferential ACP tariff quota was an atavism from Europe's not-so-splendid colonial past. It was carved out in the context of the Lomé Convention.

⁴ See IATRC (2001: 163).

⁵ GATT DS/32R (*Bananas I*) and GATT DS/38R (*Bananas II*), respectively.

country-specific quota allocations under the EC's global MFN tariff quota for Venezuela, Costa Rica, Colombia, and Nicaragua.⁶ At the creation of the WTO in 1994, the BFA was annexed to the European Communities' tariff schedule.

Ecuador and the United States, among others, challenged the CMOB under the newly created WTO dispute-settlement body (DSB) in September 1995. In particular, the complainants alleged that EC Regulation 404/93, from 1993 (the Original Banana Import Regime) was inconsistent with WTO rules and was justified neither by the BFA, nor the Agreement on Agriculture, nor was it covered by the Lomé Article I Waiver. The EC lost both in front of the original panel and the Appellate Body.⁷ After this defeat, the EC amended its banana import regime by enacting EC Regulation 2362/98 in combination with Council Regulation 1637/98 (the Compliance Banana Import Regime). As the first compliance Panel confirmed, this Compliance Banana Import Regime was an unsuccessful attempt to comply with the original DSB rulings and recommendations.⁸

As a response to the DSU Article 22.6 arbitration, which granted both the United States and Ecuador the authorization to suspend concessions and other obligations, the EC concluded two (nearly identical) 'Understandings on Bananas' with Ecuador and the US in 2001. In both Understandings, whose pertinent parts are replicated below, the EC promised to introduce a *tariff-only* regime for banana imports *no later than* 1 January 2006. In the interim, the EC was obligated to implement a tariff-quota import regime on the basis of historical licensing effective as of 1 July 2001 (para. C). While the EC notified both Understandings to the DSB as 'mutually agreed solutions', the US and Ecuador, in separate communications, stated that the Understanding did not constitute a mutually agreed solution pursuant to DSU Article 3.6; rather, the Understandings identified the *means* by which a long-standing dispute could be solved.⁹

On 14 November 2001, the Ministerial Conference adopted two waivers concerning the EC banana import regime. The Doha Article I Waiver (Article I Waiver), which includes an Annex on Bananas (Bananas Annex), granted ACP countries

⁶ The pertinent parts of the BFA are replicated below.

⁷ On 25 September 1997, the DSB adopted the AB Report as well as four separate Panel Reports in the original *EC–Bananas III* case (WT/DS27/AB/R, WT/DS27/R/ECU, WT/DS27/R/GTM, WT/DS27/R/HND, WT/DS27/R/MEX, WT/DS27/R/USA). The AB found that EC Regulation 404/93, from 1993 ('the Original Banana Import Regime') was inconsistent with WTO rules and was not justified by either the BFA or the Lomé Article I Waiver. The Original Bananas Import Regime constituted a violation of GATT Articles I:1, II, III:4, and XIII, as well as GATS Article XVII.

⁸ The Compliance Banana Regime foresaw a duty-free tariff quota of 857,000 mt for banana suppliers originating in ACP countries, a tariff quota of 2,553,000 mt with a tariff of €75/mt for all MFN suppliers, as well as a €200 tariff preference on out-of-quota imports for ACP countries. Predictably, the compliance Panel ('the first compliance panel') found that the Compliance Banana Import Regime taken by the EC to implement the DSB's rulings and recommendations were inconsistent with GATT Articles I and XIII, as well as GATS Articles II and XVII and made suggestions pursuant to DSU Article 19.1 how the EC could bring its measures into conformity. The Panel report was not appealed and was adopted on 6 May 1999.

⁹ AB Report, paras. 8, 207, 208.

preferential tariff access to the market of the EC.¹⁰ The Doha Article XIII Waiver (Article XIII Waiver) concerned the EC's separate autonomous tariff quota of 750,000 mt for bananas of ACP origin and was intended to expire on 31 December 2005, thus covering the entire period until the entry into force of the EC's tariff-only regime on 1 January 2006, as promised in the Understanding on Bananas.

On 29 January 2001, the EC adopted yet another banana import regime, which shall be called the 'Interim Banana Import Regime'. This import regime was in place between 2001 and the end of 2005.¹¹ It is worthy of note that the EC's Interim Banana Regime was never challenged by any WTO Member.

In view of the enlargement of the EU, the EC informed the WTO of its intention to rebind its bananas tariff schedule under GATT Article XXVIII on 31 January 2005. Pursuant to the earlier agreement under the Bananas Annex attached to the Article I Waiver of 2001, a two-stage arbitration process set in, in which the arbitrator assessed whether the EC's rebinding proposal would result in at least maintaining total market access for MFN banana suppliers. Two consecutive arbitrations in August and October of 2005 rejected the EC's final proposal.¹²

On 1 January 2006, instead of enacting a tariff-only regime (as promised in the 2001 Understanding on Bananas), EC Regulation 1964/2005 entered into force, which established a tariff rate of €176/mt on all banana imports, as well as a special zero-tariff quota of 775,000 mt set aside for bananas of ACP origin. This is the measure at issue for the purposes of these proceedings. As a response, Ecuador, for the second time, requested the establishment of a compliance Panel pursuant to DSU Article 21.5. In its request, Ecuador claimed inconstancy of the EC Banana Import regime adopted by the EC, *inter alia*, under EC Regulation 1964/2005. The United States followed suit soon thereafter.¹³

10 The Bananas Annex set out a special two-stage arbitration process, in case the EC was planning on rebinding its tariff on bananas. Subject to the fulfillment of the rebinding requirements, it was agreed that the Article I Waiver applied until 31 December 2007, or until after the second rebinding arbitration was concluded and the 'new regime' had entered into force, whichever applied first.

11 Based on EC Regulations 216/2001 and 2587/2001 this Interim Banana Import Regime comprised a tariff quota 'A' of 2,200,000 mt for all suppliers at a tariff of 75€/mt for MFN suppliers and a zero tariff for ACP exporters; a tariff quota 'B' of 453,000 mt for MFN suppliers at 75 €/mt for MFN suppliers and a zero tariff for ACP; and a tariff quota 'C' of 750,000 mt reserved exclusively for ACP suppliers at a tariff rate of zero. The out-of-quota tariff gave a tariff preference of €300/mt to ACP countries.

12 The EC's final tariff modification proposal consisted of an MFN tariff rate for bananas of €187/mt and a 775,000 mt duty-free quota import of ACP bananas. The arbitrators concluded that the EC had failed to rectify the matter in accordance with the Annex on Bananas, which caused the Article I Waiver to legally expire on 1 January 2006 (see Annex on Bananas, fifth tiret; reproduced in footnote 481 of the AB Report).

13 It is noteworthy that this Bananas Import Regime only marginally differs from the Compliance Banana Regime of 1998 (cf. footnote 8 above). This was acknowledged by the AB in its Report (para. 352), when stating: 'We agree with the Panel that the main difference between the tariff quota regime examined by the first Ecuador Article 21.5 panel [the Compliance Banana Regime] and the EC Bananas Import Regime at issue in these proceedings is the level of the quantitative limit (857,700 versus 775,000 mt of duty-free imports) [footnote omitted]. However, that difference is of no relevance [for the questions at issue].'

While the compliance proceedings were underway, but before the issuance of the interim report in the US Panel, the EC adopted Council Regulation 1528/2007, as a latest reform in its long lists of banana import regimes. This ‘Novel Banana Import Regime’ repealed all earlier banana import regulations and eliminated the contentious preferential tariff-free quota of 775,000 mt for ACP countries, and thus finally instituted a pure tariff-only import regime.

2.2 *Relevant documents*

Three documents are particularly pertinent for understanding the background of this case. These are: (i) relevant parts of the EC Tariff Schedule annexed to the GATT; (ii) passages from the Banana Framework Agreement, which is annexed under ‘Other terms and conditions’ to the EC Tariff Schedule in column 7; and (iii) pertinent passages from the 2001 Understanding on Bananas that the EC concluded with the United States and Ecuador after having lost the Article 22.6 arbitration.

Part I, Section I-B (Tariff Quotas) of the European Communities’ Schedule reads:

Description of product	Tariff item number(s)	Initial quota quantity and in-quota tariff rate	Final quota quantity and in-quota tariff rate	Implementation period from/to	Initial negotiating right	Other terms and conditions
1	2	3	4	5	6	7
Fresh bananas, other than plantains	0803 00 12	2,200,000 t 75 ECU/t	2,200,000 t 75 ECU/t			As indicated in the Annex

The ‘Annex’ contains the text of the Bananas Framework Agreement, which reads in relevant parts:

1. The global basic tariff quota is fixed at 2,100,000 t for 1994 and at 2,200,000 t for 1995 and the following years, subject to any increase resulting from the enlargement of the Community.
2. This quota is divided up into specific quotas allocated to the following countries:

Country	Percentage of the global quota
Costa Rica	23.4
Colombia	21.0
Nicaragua	3.0
Venezuela	2.0
Dominican Republic and other ACP concerning non-traditional quantities	90.000 t.
Others	46.32 % (1994)–46 % (1995)

7. The in-quota tariff rate shall be 75 Ecus/tonne.
8. The agreed system will be operational by 1 October 1994 at the latest, without prejudice to any provisional or transitional measures to be examined for the year 1994.
9. This agreement shall apply until 31 December 2002. Full consultations with the Latin American suppliers that are GATT Members should start no later than in year 2001.
The functioning of the agreement will be reviewed before the end of the third year, with full consultation of GATT Member Latin American suppliers.
10. This agreement will be incorporated into the Community's Uruguay Round Schedule.
11. This agreement represents a settlement of the dispute between Colombia, Costa Rica, Venezuela, Nicaragua and the Community on the Community's banana regime. The parties to this agreement will not pursue the adoption of the GATT panel report on this issue.

The two Understandings on Bananas, concluded pursuant to the original *Bananas III* dispute between the EC and Ecuador and US, respectively, provide in paras. B and C (Ecuador and United States) and G (Ecuador):

- B. In accordance with Article 16(1) of Regulation No. (EEC) 404/93 (as amended by Regulation No. (EC) 216/2001), the European Communities (EC) will introduce a Tariff Only regime for imports of bananas no later than 1 January 2006 ...
- C. In the interim, the EC will implement an import regime on the basis of historical licensing as follows:
 1. Effective 1 July 2001, the EC will implement an import regime on the basis of historical licensing as set out in Annex 1.
 2. Effective as soon as possible thereafter, subject to Council and European Parliament approval and to adoption of the Article XIII waiver referred to in paragraph F, the EC will implement an import regime on the basis of historical licensing as set out in Annex 2. The Commission will seek to obtain the implementation of such an import regime as soon as possible.
- G. The EC and Ecuador consider that this Understanding constitutes a mutually agreed solution to the bananas dispute.

2.3 *Arguments by the complainants and findings by the compliance Panel*

Both Ecuador and the United States initiated Article 21.5 proceedings claiming continued WTO inconsistency of EC Regulation 1964/2005 and related measures (the Bananas Import Regime). Ecuador – for the second time – claimed that the EC had ‘failed to implement the rulings and recommendations of the DSB in the original dispute and continues to be in breach of its obligations as a WTO Member’. In particular, Ecuador requested that the Panel find that the EC measures are inconsistent with: (i) GATT Article I, ‘because the European Communities applies different and more favourable duties to bananas originating

in ACP countries than those applied to bananas originating in Ecuador and most or all other WTO members’; (ii) GATT Article II, ‘because the European Communities applies a tariff (currently €176/mt) on the import of bananas originating in Ecuador (and other WTO Members) that is above the EC bound rate of duty under Article II, which is €75/mt’; and (iii) GATT Articles XIII:1 and 2, ‘because the European Communities continues to provide a tariff rate quota system reserved exclusively for bananas of ACP origin, while Ecuador is denied any share of the preferential quota, let alone the share to which it is entitled under Article XIII’.¹⁴

The US also claimed that the EC had ‘failed to implement the rulings and recommendations of the DSB in the original dispute and continues to be in breach of its obligations as a WTO Member’. Specifically, the United States requested that the Panel find that the EC measures are inconsistent with: (i) GATT Article I, ‘because the European Communities applies a zero tariff rate to imports of bananas originating in ACP countries in a quantity up to 775,000 mt, but does not accord the same duty-free treatment to imports of bananas originating in all other WTO Members’; and (ii) GATT Articles XIII:1 and 2, ‘because the European Communities reserves the 775,000 mt zero-duty tariff quota for imports of bananas originating in ACP countries and provides no access to this preferential tariff quota to imports of bananas originating in non-ACP substantial or non-substantial supplying countries’.¹⁵

The compliance Panel rejected various procedural arguments and preliminary issues brought forth by the EC and found violations of GATT Articles I, II, and XIII. It recommended that the DSB request the EC to bring its inconsistent measures into conformity with its obligations under the GATT 1994.¹⁶

3. Claims on appeal, findings of the AB, and some observations

In this section, we summarize the claims on appeal and the AB’s findings and offer a few observations. We start with procedural issues (subsection 3.1) and then discuss substantive questions before the AB (subsection 3.2).

3.1 Procedural issues

3.1.1 Article 9.3 DSU and Rule 20(2)(d)(i) of AB Working Procedures

Two preliminary procedural issues were raised on appeal and both were rejected by the AB. The EC alleged that the Panel acted inconsistently with DSU Article 9.3 by failing to harmonize the timetables of the proceedings in the Ecuador and

¹⁴ Compliance Panel Report, *EC–Bananas III (Ecuador)* (21.5, *Second Recourse*), para. 3.1.

¹⁵ Compliance Panel Report, *EC–Bananas III (United States)* (21.5, *Second Recourse*), para. 3.1.

¹⁶ Compliance Panel Report, *EC–Bananas III (Ecuador/United States)* (21.5, *Second Recourse*), paras. 8.1–8.5.

US cases. The EC requested that the Panel's failure to harmonize the timetables 'be reversed'.¹⁷ The United States, on the other hand, as an appellee, contended that the EC's Notice of Appeal did not satisfy the requirements of Rule 20(2)(d)(i) of AB Working Procedures because the EC allegedly had failed to identify just which findings it deemed to be erroneous because it failed to mention the paragraph numbers of the US Panel Report to which the issues appealed related. The US requested that the AB dismiss the EC's appeal entirely.

In both cases, the AB continued its practice of rejecting procedural claims that are not supported by a showing of actual denial of due process. In the case of the EC's Article 9.3 claim, the AB held that 'the mere possibility that due process rights of the European Communities could have been adversely affected by the Panel's decision to maintain separate timetables in these proceedings is not sufficient to establish that the due process rights of the European Communities have indeed been compromised'.¹⁸ Similarly, in the United States's appeal, the AB ruled that 'the deficiencies in the European Communities' Notice of Appeal do not lead to dismissal of the European Communities' appeal', since even the US in the oral hearing had acknowledged that it had not been 'prejudiced by the absence of paragraph numbers'.¹⁹

3.1.2 *The legal effect of the Understandings on Bananas and the use of estoppel in the WTO*

The AB affirmed, for different reasons, the Panel's rejection of the EC's argument that the legal effect of the Understandings on Bananas was to preclude the complainants from initiating compliance proceedings. The dispute centered on the question whether the Understandings amounted to a 'solution mutually acceptable to the parties to the dispute and consistent with the covered agreements' within the meaning of Article 3.7 of the DSU, and, if so, whether such agreed solution could preclude the complainants from bringing their claims under Article 21.5 DSU.

The Panel had found that the complainants could be barred from initiating compliance proceedings only if the Understandings constituted a 'positive solution and effective settlement of the dispute'. The AB disagreed with this legal test, but agreed with the Panel that the complainants were not barred from initiating compliance review.

Nothing in Article 3.7, the AB noted, 'establishes a condition under which a party would be prevented from initiating compliance proceedings'.²⁰ Members do not waive recourse to Article 21.5 review simply by entering into a mutually agreed solution absent 'a clear indication in the agreement between the parties of a relinquishment of the right to have recourse to Article 21.5'.²¹

¹⁷ AB Report, para. 30.

¹⁸ AB Report, para. 197.

¹⁹ AB Report, para. 283.

²⁰ AB Report, para. 211.

²¹ AB Report, para. 212.

In the course of its analysis, the AB expressed its disagreement with two intermediate conclusions of the Panel. The first was the Panel’s reasoning that the conclusion of the Understandings *after* adoption of the original rulings and recommendations by the DSB was relevant to the question whether complainants were barred from bringing 21.5 review proceedings. ‘We see nothing in Article 3.7 or elsewhere in the DSU ... that would preclude recourse to Article 21.5 proceedings after the adoption of recommendations and rulings by the DSB’, the AB said.²² It went on to note that ‘the DSU itself clearly envisages the possibility of entering into mutually agreed solutions after recommendations and rulings are made by the DSB’.²³ In addition, the AB disagreed with the Panel’s reliance on ostensibly conflicting statements as to the legal nature of the Understandings made at the DSB after they were signed.²⁴ Such statements, the AB said, may be taken into account where the interpretation of a document is not clear, but they have limited relevance when documents are unambiguous. ‘[E]x post communications of the parties concerning the Understandings have, at best, slight evidentiary value.’²⁵

While the AB used several paragraphs²⁶ to discuss the text of the two Understandings, its main point was that, in order for a party to be barred from recourse to Article 21.5, the mutually agreed solution must explicitly state that the complainant relinquishes that right.²⁷ Thus, even though the Understanding involving Ecuador declared in paragraph G that ‘[t]he EC and Ecuador consider that this Understanding constitutes a mutually agreed solution to the banana dispute’, this statement did not entail a waiver of its Article 21.5 review rights by Ecuador.²⁸

Finally, the AB agreed with the EC that the Panel had erred in its interpretation and application of the ‘good faith’ requirement of Article 3.10 DSU, but upheld the Panel’s conclusion that Ecuador and the US had acted in good faith in bringing the review proceeding. According to the AB, its Report in *US–Offset Act (Byrd Amendment)* was misread by the Panel.²⁹ In *US–Byrd*, the AB noted, it had addressed the principle of good faith as it relates to a substantive provision. In *Bananas III*, the case before it now, on the other hand, the Panel and the AB had to consider the principle as a procedural impediment for a Member to initiate review proceedings.³⁰

In the course of its discussion on this point, the AB stated that, while the EC did not use the term, it was in fact advancing an *estoppel* argument.³¹ It quoted from its

22 AB Report, para. 215.

23 Ibid.

24 See footnote 9 and accompanying text.

25 AB Report, para. 216.

26 AB Report, paras. 217–222.

27 AB Report, para. 221.

28 Ibid.

29 AB Report, para. 227.

30 Ibid.

31 Ibid.

Report in *EC–Export Subsidies on Sugar*,³² that ‘even assuming *arguendo* that the principle of estoppel could apply in the WTO, its application would fall within these narrow parameters set out in the DSU’.³³ The ‘narrow parameters’ referred to are those of DSU Article 3.10 regarding good faith in deciding to have recourse to dispute settlement.

The estoppel allegations in both *EC–Sugar* and *Bananas III* involved the question of whether a complaining Member should be barred from proceeding with its complaint. However, in the context of working procedures for a dispute-settlement proceeding, the two Panels and the AB have employed the estoppel principle, but – as with the EC in *Bananas III* – without using the term.³⁴ Thus, for example, in *US–Steel Plate*, the Panel denied India the right to pursue a claim that it had explicitly abandoned in its first written submission.³⁵ Similarly, in *Mexico–Corn Syrup (Article 21.5 – US)*, the AB held that failure to pursue an objection to the absence of consultations before the DSB prevents a Member from arguing that the Panel was improperly established. ‘A Member that fails to raise its objections in a timely manner, notwithstanding one or more opportunities to do so, may be deemed to have waived its right to have a panel consider such objections.’³⁶ Even though words such as ‘waiver’ are used instead of ‘estoppel’, decisions of this kind amount to estoppel within the conduct of a case. This, of course, is a very different matter from holding that a Member is estopped from even initiating a proceeding in the first place.

3.1.3 ‘Repeal’ of the challenged measures

In the case of the United States’s Report, the EC argued that the Panel was wrong in making findings with respect to a measure that had ceased to exist.³⁷ The EC contended that the Panel had acted inconsistently with its obligation under Articles 3.4 and 3.7 of the DSU, which instruct panels to secure a positive solution to the dispute. In addition, the EC alleged that the Panel had provided a ‘concealed’ recommendation by stating that the original DSB recommendations and rulings ‘remained operative’.³⁸

With respect to the Panel having made *findings* on an expired measure, the AB cited its earlier ruling in *US–Upland Cotton*, where it had held that ‘whether or not a measure is still in force is not dispositive of whether that measure is currently

32 Appellate Body Report, *European Communities – Export Subsidies on Sugar*, WT/DS265/AB/R, WT/DS266/AB/R, WT/DS283/AB/R, adopted 19 May 2005.

33 AB Report, para. 227, quoting *EC–Export Subsidies on Sugar*, para. 312.

34 See Palmeter and Mavroidis (2004: 43–45, 78).

35 DS206/R, 29 July 2002, para. 7.29.

36 AB Report, *Mexico–Corn Syrup (WT/DS132/AB/RW)*, at para. 50.

37 The reader is reminded that in 2007, the EC enacted the ‘Novel Bananas Import Regime’ (EC Regulation 1528/2007) which replaced the zero-percent tariff quota afforded exclusively to ACP countries of the Bananas Import Regime under EC Regulation 1964/2005.

38 AB Report, paras. 45–48.

affecting the operation of any covered agreement’.³⁹ The AB reminded that the present case is different from *US–Upland Cotton* in that the measure on appeal in these proceedings was still in full force at the time the Panel was established and expired only towards the end of the Panel proceedings.⁴⁰ With respect to the EC’s allegation that the Panel had made ‘concealed’ *recommendations*, the AB stated that it does ‘not believe that the Panel made a specific recommendation’, reminding that the Panel in its Report in the US 21.5 challenge (at para. 8.13) had stated that it ‘*makes no new recommendation*’ and that the ‘original DSB recommendations and rulings in this dispute remain operative’.⁴¹ Consequently, the AB deemed it within the discretion of a panel to decide how it takes into account subsequent modifications or a repeal of the measures at issue.

The authors of this commentary believe that the AB was right in upholding Panel findings on the expired measure. If repealed policies could not be decided upon by WTO dispute panels, then Members would have an easy time engaging in strategic gamesmanship by entering into a repeal/amendment strategy, where the amended measure nominally replaces its ancestor yet shares most of its characteristics. A Member would never be able to challenge the measure at issue – simply because the respondent would make sure that it is not ‘at issue’ anymore, thanks to repeal and amendment. A decision with respect to an expired measure is also efficient, since it makes consecutive ‘measures taken to comply’ vulnerable in later 21.5 proceedings if it is too close to the original measure.

3.1.4 *Legal effect of Panel suggestions and the relationship of Articles 19.1 and 21.5 of the DSU*

In the Ecuador case, the EC requested that the AB dismiss Ecuador’s claims under Article XIII, because the latter’s ‘claims are in reality a challenge on the measures *suggested* by the [first Ecuador Article 21.5] Panel, rather than on the measures *actually taken* by the European Communities’.⁴² The EC maintained that, once a Panel or AB report, containing suggestions made pursuant to Article 19.1 DSU, has been adopted, ‘the consistency of the *measures suggested* by the original panel with the covered agreement cannot be challenged by the complaining party before an Article 21.5 panel’, because parties are obliged to ‘unconditionally accept’ the DSB’s recommendations, rulings, and suggestions, by virtue of Article 17.14 read in combination with Article 16.4 DSU.⁴³ According to the EU, the compliance Panel should have first checked if the challenged measures were indeed the measures suggested by the original panel. And if the EC has effectively implemented any of the suggestions made by the first compliance Panel, the Panel

39 AB Report, para. 267.

40 AB Report, para. 269.

41 AB Report, paras. 272, 273.

42 AB Report, para. 317, emphasis in original.

43 AB Report, para. 317, emphasis in original.

should rule ‘without any further analysis’ that these measures are consistent with the covered agreements.

The AB assessed the legal nature of the Panel or AB suggestions pursuant to Article 19.1 DSU and found that suggestions, while potentially providing useful guidance, following a Panel suggestion does not guarantee substantive compliance with the rulings and recommendations by the DSB. Interpreting the language of Articles 19.1 and 21.5 of the DSU, the AB ruled that suggestions are not themselves the subject of review and a compliance Panel is limited to the assessment of the existence or consistency with the covered agreements of the *measures* taken to comply with the rulings and recommendations, but not of previous suggestions made. Hence, the AB upheld the Panel’s finding that the adoption by a Member of a measure that directly implements a suggestion made by a Panel pursuant to Article 19.1 DSU does not prevent a complaining party from challenging the consistency of that measure with the covered agreements in an Article 21.5 proceeding.

Article 19.1 DSU authorizes Panels and the AB to ‘suggest ways in which the Member concerned’ may come into compliance. This rarely used authority was utilized by the first Article 21.5 Panel requested by Ecuador.⁴⁴ Based on this suggestion, the EC argued to the AB that Ecuador’s claim under Article XIII GATT should be dismissed. According to the EC, the WTO consistency of measures suggested by a Panel cannot be challenged in a compliance review. The EC reasoned that adoption of reports under Articles 16.4 and 17.14 of the DSU covers all the recommendations and rulings in the report, including any suggestions as to compliance.⁴⁵

The EC’s argument was rejected by the AB. Article 19.1 DSU, it noted, neither directly addresses the legal status of suggestions, nor are they subject to review.⁴⁶ However, “‘measures taken to comply *with the recommendations and rulings*”, but not “‘measures taken to comply *with suggestions*” are subject to Article 21.5 review, regardless of whether those measures were suggested.⁴⁷ ‘The adoption of a panel or Appellate Body report by the DSB makes the recommendations and rulings therein binding upon the parties’, the AB held. But ‘adoption by the DSB does not make suggestions for implementation binding upon the parties’.⁴⁸ ‘Even if the measure taken to comply conformed to a suggestion made, this would not bar [a Member] from bringing Article 21.5 proceedings to determine whether the implementing measure achieves full compliance with the DSB recommendations and rulings.’⁴⁹ Further, the Appellate Body noted that ‘the fact that a Member has

44 Compliance Panel Report *EC–Bananas (Ecuador) (21.5, First Recourse)*, paras. 6.154–6.159.

45 AB Report, para. 317.

46 AB Report, para. 322.

47 *Ibid.* (emphasis added).

48 AB Report, para. 323.

49 AB Report, para. 324.

chosen to follow a suggestion *does not* create a presumption of compliance in Article 21.5 proceedings'.⁵⁰

We believe the AB's reasoning is sound. Full compliance with DSB rulings cannot simply be presumed just because the respondent declares that its measure taken to comply conforms to the Panel's suggestions under Article 19.1 DSU.⁵¹ This would unduly change the nature of the obligation from one of complying with the rulings and recommendations, based on certain WTO provision(s) to implementing compliance suggestions. Also, the parties see compliance suggestions for the first time when they receive the Panel's report. They have no opportunity to address – much less to challenge – a proposed suggestion. Yet, a suggestion that might seem to result in compliance may, upon further examination, fail to do so.⁵² A complaining Member should not be denied 'its day in court' to challenge directly the question of whether a measure taken to comply in fact does so, whether or not that measure has been suggested.

Petros Mavroidis suggests that, irrespective of the legal force of a suggestion, a WTO Member that has accepted a suggestion should be presumed to be in compliance.⁵³ Provided this is a rebuttable presumption, we would agree. But such a presumption would seem to be of little, if any, benefit to the Member concerned, since a complaining Member challenging a measure taken to comply effectively already has the burden of proving non-compliance in any event. True, if a compliance Panel is composed of the same individuals who made the suggestion, a complaining Member might, as a practical matter, face an uphill challenge. At the AB stage, the complaining Member might face an even more difficult challenge because there is no further appeal. This suggests that the AB has been wise not to make suggestions, in part because of its short timetables, when it has not had the opportunity to benefit from briefings and arguments from the parties on any particular suggestion.

An irrebuttable presumption would deny complaining Members a fair opportunity to challenge the substance of a measure taken to comply that follows a suggestion and clearly does not seem to be justified by the terms of Article 19.1.

⁵⁰ AB Report, para. 325 (emphasis added).

⁵¹ AB Report, para. 323.

⁵² As an example, the authors of this commentary are not certain whether the suggestions of the Article 21.5 Panel were entirely GATT conforming. The Panel suggested that the EC could bring its measures into conformity by, inter alia, 'maintaining its bound and autonomous MFN tariff quotas ... by allocating ... shares by agreement with all substantive suppliers consistently with Article XIII:2 of the GATT 1994. The MFN tariff quota could be combined with ... a preferential tariff quota for ACP countries, provided a waiver from Article XIII of the GATT 1994 was obtained' (Panel Report, *EC–Bananas III* (Article 21.5 – Ecuador), paras. 6.156–6.158). However, such a tariff preference to ACP countries seems to nevertheless violate Article I:1 of the GATT.

⁵³ See the contribution of Mavroidis in this volume. See also Mavroidis (2007: 416) and Mavroidis (2000).

3.1.5 Article 3.8 DSU and nullification or impairment suffered by the US and Ecuador

As a final procedural issue, the EC requested that the AB reverse the Panel's legal interpretations that the ACP preference in the Banana Import Regime had caused nullification or impairment (NoI) to Ecuador or the United States. In the case of Ecuador, the EC argued that the quantity limitation on ACP imports entering at zero-tariff was actually a 'benefit' to Ecuador, because it put a 'cap' on the preferential treatment of ACP countries and consequently limited the amount of duty-free ACP banana imports. In addition, the EC argued that the Panel had failed to explain how the measure at issue had caused NoI *over and above* that already found under GATT Article I (a finding that the EC had not appealed). According to the EC, the Panel engaged in 'double counting' of NoI by adding to the negative effects caused by the ACP preference under Article I GATT the 'limitation of these negative effects through the quantity limit'.⁵⁴

The AB dismissed the EC's claims, stating that both infringements of Article I and Article XIII GATT trigger the presumption of NoI. Nullification or impairment resulting from inconsistencies with Articles I and XIII GATT may thereby 'coincide' or 'overlap'.⁵⁵ However, such coincidence and overlap is only relevant to the calculation of the total level of NoI suffered for the purposes of an arbitration pursuant to DSU Article 22.6. According to the AB, it is not for the AB to decide on the extent of such overlap, and a demonstration by the EC that NoI may overlap is not sufficient to rebut the presumption in Article 3.8 DSU that any of these infringements constitutes a *prima facie* case of NoI.

In the case of the United States, the EC claimed that the Panel had confused the notion of 'nullification or impairment' with that of 'legal standing' in that the US had never been deprived of any competitive opportunities to export bananas. The EC pointed out that the US had always been a net importer of bananas and had never exported bananas to any country in the world, let alone the EU.

The AB agreed with the EU that 'standing' is a broader concept than NoI, but concluded that the Panel did not confuse those two issues. It ruled that it was insufficient for the EC to allege that the Panel had failed to explain the effect on the US internal market, noting that the burden of rebutting the presumption resides with the EC. Citing *US-Superfund*, the AB supported the Panel's finding that 'the arguments advanced by the European Communities on the alleged lack of nullification or impairment have not rendered irrelevant the considerations made by the panel and by the Appellate Body in the course of the original proceedings, regarding the actual and potential trade interests of the United States in this dispute'. The AB agreed with the earlier panels that the US is a producer of bananas and that a potential export interest by the United States thus cannot be excluded. It also held that 'the internal market of the United States for bananas could be affected by

⁵⁴ AB Report, para. 77.

⁵⁵ AB Report, para. 360.

the EC bananas regime and by its effects on world supplies and world prices of bananas’,⁵⁶

This conclusion is consistent with earlier jurisprudence of both the AB and Panels. In the initial *Bananas III* proceedings, for example, both the original panel and the AB had found that it is not necessary for a Member to have a ‘legal interest’ as a prerequisite to initiating dispute settlement.⁵⁷ The Panel in *Korea–Dairy* interpreted ‘legal interest’ to mean ‘economic interest’ and concluded that ‘under the DSU there is no requirement that parties have an economic interest’.⁵⁸

We end this section with a general observation from the AB’s examination of procedural issues: at various instances, the AB digressed and examined issues that were not pertinent for reaching its conclusions.⁵⁹ The question whether a tribunal’s ruling should be narrowly focused on the facts of the case before it, or whether it should be broader than the minimum necessary to decide the case, has long been a matter of jurisprudential dispute. There are advantages and disadvantages to each approach.

A judicially modest, narrow ruling has the advantage of not anticipating problems that have not yet arisen and not foreclosing argument that might arise when those problems are squarely presented. It allows fine distinctions to be drawn between different factual situations, and reduces risk of unintended and unanticipated consequences. On the other hand, it can lead to uncertainty by leaving parties in the dark as to how a tribunal might rule in future cases with slightly different factual situations. It therefore can result in further, extended, litigation to settle outstanding questions.

A broad ruling, on the other hand, has the advantage of providing guidance to interested parties, thus reducing the need for further litigation to resolve outstanding questions. But it risks making unanticipated errors as the tribunal moves into areas that were not thoroughly aired during the course of the dispute.

In *Bananas III*, the AB adopted both approaches. When considering whether the Understanding on Bananas was a ‘measure taken to comply’, the AB noted that ‘strictly speaking, we would not be required to assess whether the EC Bananas Import Regime fell within the scope of Article 21.5 because of a “particularly close relationship” to the declared measure taken to comply’.⁶⁰ However, because the Panel made findings on this question, and because the parties argued it before the AB, the AB addressed the question and made additional findings.⁶¹

⁵⁶ AB Report paras. 458 and 466.

⁵⁷ Original Panel Report *EC–Bananas III*, para. 7.49 and original Appellate Body Report, para. 132, note 64.

⁵⁸ Panel Report, *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products*, as modified by the Appellate Body, WT/DS98/AB/R, para. 7.13.

⁵⁹ For example, AB Report at paras. 213–216, 252–255.

⁶⁰ AB Report, para. 252.

⁶¹ *Ibid.*

At a later point in its opinion, discussed above, the AB found that it did not need to decide whether nullification and impairment resulting from an inconsistency in quota allocation under Article XIII may coincide or overlap with that resulting from an inconsistency of a tariff preference with Article I:1.⁶²

The AB was probably correct in both instances. Rather than adopt an iron-clad rule, it seems wiser to approach this question as the AB did, with an eye to the specific situation it faces. When dealing with a question that had been dealt with by the Panel and argued by the parties on appeal, it went ahead and offered its views on the issue. But when dealing with an issue implicating aspects of Article I, Article XIII, and tariff preferences that it did not have to decide, it wisely took a narrow, cautious approach.

3.2 *Substantive issues*

3.2.1 *Non-discriminatory administration of tariff quotas under Article XIII*

On substance, the EC appealed the Panel's findings that the duty-free tariff quota reserved for ACP banana imports falls within the scope of Article XIII GATT and was inconsistent with Articles XIII:1, XIII:2, and XIII:2(d), which regulate the non-discriminatory application of quantitative restrictions and tariff quotas.

The EC essentially brought forth three arguments, all of which the AB rejected.

The first argument the EC made was that Article XIII does not apply at all in the case of tariff quotas, since Article I GATT prevailed over Article XIII in case of an overlap of the two provisions. The EC claimed that the Panel had developed a flawed theory pursuant to which a lower tariff offered to one Member automatically becomes a quantitative restriction on all other Members as soon as it was accompanied by a quantitative cap. According to the EC, such an interpretation would deprive the MFN principle of Article I:1 GATT of any value and would render WTO-inconsistent limitations on trade preferences offered by developed countries to developing countries under the 'Enabling Clause'.

In response to the EC's claim, the AB assessed the relationship between Articles I and XIII GATT. According to the AB, tariff quotas thus must comply with both Articles I:1 and XIII. This protects Members against differential in-quota duties (thanks to Article I GATT), against discriminatory access to quota shares (Article XIII:1), and against discriminatory administration of quota allocation (Article XIII:2). In the absence of Article XIII, Article I would not provide specific guidance on how to administer tariff quotas in a non-discriminatory fashion in the allocation of quota shares. Hence, the AB determined that with respect to tariff quotas the application of Article I does not prejudice the application of Article XIII.

As its second argument, the EC challenged the applicability of Article XIII:1 because of the identity of the party affected by the 'restriction' in place. According to the EU, the Panel had misinterpreted the notion of 'quantitative restriction'

⁶² AB Report, para. 361.

contained in Article XIII:1 because the limitation on the tariff preference for ACP suppliers did not constitute a restriction *imposed on the imports of the ‘aggrieved Member’* (i.e. on imports originating in the complainants’ territory), but on imports from third countries (namely the ACP countries). As a consequence, the EC contended that there was ‘no basis that would allow an examination of whether “similar” quantitative restrictions are also imposed on all other countries’.⁶³

In addressing this question, the AB read Article XIII:1 with reference to a tariff quota and stated: ‘Article XIII:1 is rendered thus: no *tariff quota* shall be applied by a Member on the importation of any product ... of any other Member, unless the importation of the like product of all third countries is similarly made subject to the *tariff quota*.’ Taking a broad interpretation of the term ‘restriction’, the AB ruled that imports of like products of all third countries must have access to, and be given an opportunity for, participation.⁶⁴ Applying Article XIII:1 to the facts of the case, the AB ruled that since the zero-tariff quota reserved for ACP countries plainly excluded non-ACP countries, the tariff quota did not equally apply to, or similarly restrict imports of, like products from MFN countries, thus offending the principle of access to, and participation in, a tariff quota enshrined in Article XIII:1.⁶⁵

The third argument brought by the EU was that Article XIII:2 on non-discriminatory distribution of tariff quotas did not apply to the EC import regime *vis-à-vis* Ecuador and the US, because both countries were not even subject to the Banana Import Regime in question. Since the contentious EC tariff quota only concerned imports from ACP countries, imports from the US and Ecuador were only subject to a simple tariff – an issue that should be dealt with under Article I of the GATT.

The AB explained that Article XIII:2 regulates the distribution of tariff quotas among Members. It noted that ‘the chapeau of Article XIII:2 requires that the tariff quota be distributed so as to serve the aim of a distribution of trade approaching as closely as possible the shares that various Members may be expected to obtain in the absence of the tariff quota’.⁶⁶ The AB continued that Article XIII:2(d) on historical allocation of quota shares is a permissive safe haven: compliance with the requirements of Article XIII:2(d) is presumed to lead to a distribution of trade as foreseen in the chapeau of Article XIII:2. Examining the EU Banana Import Regime under these provisions, the AB stated that ACP preference failed to meet the requirements regarding the distribution and allocation of shares

63 AB Report, para. 70.

64 AB Report, para. 337 (emphases added). On this issue, the AB disagreed with a particular interpretation of the term ‘restriction’ in Article XIII:1 by the Panel as ‘[a]ny benefit accorded to fresh bananas of only some Members presumably affect[ing] the competitive opportunities of like bananas imported from other Members’, stating that such overly broad interpretation would mean that even a simple tariff preference would be inconsistent with Article XIII (*ibid.*, para. 346).

65 AB Report, para. 338.

66 *Ibid.*

in Article XIII:2. It noted that the exclusion of non-ACP suppliers from the tariff quota is not aimed ‘at a distribution of trade ... approaching as closely as possible the shares which the various Members might be expected to obtain in the absence of restrictions’, as required by Article XIII:2. It further ruled that ‘the exclusion of non-ACP suppliers [does not] respect the “safe harbour” allocation requirements in Article XIII:2(d) based upon the representative proportions of Members having a substantial interest in the supply of bananas to the European Communities’.⁶⁷

The authors of this paper have four brief comments on the AB’s examination of Article XIII GATT. First, the AB was right in arguing that tariff quotas, being quotas and tariffs at the same time, must comply with the requirements of Article I:1, as well as with the non-discrimination obligation of Article XIII. Only if these provisions act in concert can abusive tariff quotas be effectively avoided: Article XIII:1 safeguards equal access to, or participation in, a certain tariff-quota regime. Once all MFN countries have equal access to a tariff quota, equal in-quota treatment must be ensured. This consists of uniform in-quota tariffs, and of equitable quota distribution among exporting countries. Article I:1 GATT safeguards the former; Article XIII:2 the latter. Hence, Articles I and XIII apply to different elements of an import measure.

Second, we believe that the AB was right in interpreting the non-discrimination tenet for quota allocation as a most-favored nation (MFN) treatment principle.⁶⁸ In the context of tariff quotas, non-discrimination could theoretically be interpreted as: (i) granting equitable shares to all (current and potential) exporters; (ii) allotting the global quota in proportion to current suppliers; (iii) first-come, first-served regime of quota filling; or (iv) as an MFN regime according to the free-trade counterfactual (see Skully, 2001).⁶⁹ However, we believe that only the MFN interpretation can satisfy the free-trade counterfactual enshrined in the chapeau of Article XIII:2, which states that ‘[i]n applying import restrictions ... contracting parties shall aim at a distribution of trade in such product approaching *as closely as possible* the shares which the various contracting parties might be expected to obtain *in the absence of such restrictions*’. Also, the language used in the Agreement on Safeguards, particularly in Article 5.2 on the application of

⁶⁷ It elaborated: ‘Allocating the entire tariff quota exclusively to ACP countries, and reserving no shares to non-ACP suppliers, cannot be considered to be based on the respective shares of ACP and non-ACP supplier countries in the European Communities’ banana market’ (ibid.).

⁶⁸ ‘Article XIII adapts the MFN-treatment principle to specific types of measures, that is, quantitative restrictions, and, by virtue of Article XIII:5, tariff quotas’ (AB Report, para. 342). ‘Article XIII ensures that a Member applying a restriction or prohibition does not discriminate among *all other* Members’ (ibid., para. 343). Per contra, see the comment to this paper by Prof. P. C. Mavroidis in this volume. The author points out that the position of Article XIII within the GATT may hint at the fact that it, just as Article XI on quantitative restrictions, was meant to be an exception to the MFN principle enshrined in Article I GATT.

⁶⁹ As Hudec (1997: 178) reports, those different positions on the interpretations of non-discriminatory allocation of quantitative restrictions were prevalent already in the 1930s, when the League of Nations-sponsored World Economic Conferences were being held.

safeguard measures, is nearly identical to certain passages in Article XIII. As many authors have argued (e.g., Jackson, 1997), the Agreement on Safeguards mandates MFN treatment of all exporters.⁷⁰ Finally, if the wording of Article XIII was meant to be an explicit departure from the fundamental WTO (and economic) principle of non-discrimination among a Member's trading partners, the founding fathers of the WTO should have made such deviation more explicit. However, nothing in the preparatory work of the WTO is suggestive of that (Hudec, 1997).

Our third comment is that despite this *de jure* MFN obligation for quota allocation in Article XIII:2, Article XIII:2(d) allows for *de facto* discrimination of certain suppliers and therefore is in striking contrast to the principles laid out in the chapeau of Article XIII:2. From an economic perspective we have to state: an alleged MFN tenet under the chapeau of Article XIII:2 cannot be reconciled with the 'safe haven' of historical quota allocation of Article XIII:2(d). This will be shown in more detail below (Section 4.1.3).

Finally, the AB was correct in rebutting the EC's peculiar notion of 'discriminatory' vs. 'preferential' quantitative restrictions (QR), which implies that an import regime falls under the purview of Article XIII, only if the complainant is a direct subject of a QR and therefore 'aggrieved'. From a political-economic perspective, such view is baseless. Given that imports under any QR are a zero-sum game among competing exporters, it is obvious that a 'preferential' QR to one set of countries – here ACP suppliers – necessarily goes to the detriment of all other countries – here MFN suppliers. Members excluded from a preferential QR necessarily are 'restricted' and therefore suffer losses relative to a situation without QR.

3.2.2 *Doha Article I Waiver as 'subsequent agreement'*

The EC Banana Import Regime provided for an MFN tariff of €176/mt on all banana imports that did not fall under the ACP tariff quota of 775,000 mt at zero tariff. In the compliance proceedings, Ecuador had requested the Panel to find WTO-inconsistency with that provision. According to Ecuador, this provision was inconsistent with the EC's tariff schedule, that is its obligations under Article II GATT, which contained an MFN tariff quota of 2.2 million mt with an in-quota tariff rate of only €75/mt. The compliance Panel had found that while the MFN tariff quota and the accompanying tariff rate of €75 had undeniably expired on 31 December 2002 (under the terms of paragraph 9 of the Banana Framework Agreement; see above), the tariff quota nevertheless had been extended through 'common intention' of all WTO Members. According to the Panel, such common intension had manifested itself in the Article I Waiver. The Panel had held that the Article I Waiver modified the Schedule of the EC, and therefore was to be considered a 'subsequent agreement regarding the *interpretation* of the original treaty'

⁷⁰ See Article 2.2 of the Safeguards Agreement (SGA): 'Safeguard measures shall be applied to a product being imported *irrespective of its source*' (emphasis added), but see Mavroidis (2007: 375).

as mentioned in Article 31(3)(a) of the Vienna Convention on the Law of Treaties (Vienna Convention).⁷¹

On appeal, the EC requested the AB to reverse this finding. It claimed that the Panel erred in determining that the Doha Article I Waiver was a subsequent agreement on the interpretation of the EC Tariff Schedule. The EC brought forth two arguments. First, even by the Panel's own standards, the Waiver did not *interpret*, but *modify* the EC Schedule by extending the tariff-quota concession beyond 31 December 2002. In addition, the Waiver did not contain any such 'common intent'.⁷²

In examining this issue, the AB set off with a general discussion on the 'roles and functions' of four basic methods that Members may use to interpret or modify WTO law: (i) waivers (Article IX:3 of the WTO Agreement); (ii) multilateral interpretations (Article IX:2); (iii) multilateral amendments (Article XI); (iv) tariff renegotiations (Article XXVIII GATT).

The AB found that waivers are specific and exceptional instruments. Their purpose is not to modify existing provisions or to create new law or add or amend obligations under a covered agreement, but to relieve certain WTO Members from obligations temporarily, subject to very tight timelines and notification requirements. Thus, the AB concluded that the Panel had erred in finding that the Article I Waiver was a subsequent agreement to the EC schedule, especially because the WTO has in stock a particular instrument dealing with tariff modification in the form of Article XXVIII.

Although it was not necessary to do so, the AB went on to examine whether there really existed a 'common intent' among parties in extending the tariff-quota concession in the EC schedule by means of the Doha Waiver.⁷³ The AB did not see how the language of the Article I Waiver had expressly extended the MFN tariff quota of 2.2 million mt, the in-quota tariff rate of €75/mt, or the terms of the BFA. It noted that the 'Doha Article I Waiver is concerned with the zero-duty preference for ACP suppliers, not with the tariff quota concession for MFN suppliers specified in the European Communities' Schedule'.⁷⁴ On this basis, the AB reversed the Panel's findings that the Doha Article I Waiver constituted a subsequent agreement reflecting the common intention of WTO Members that the EC tariff-quota

71 The Panel held that the Doha Article I Waiver was an agreement reached between the same parties that agreed to incorporate the BFA as an annex to the EC Schedule of Concessions; that it was subsequent to the BFA; and that the Waiver, just like the BFA, dealt with, inter alia, the EC's WTO market-access commitments relating to bananas. In addition, the Panel concluded that the common intention of WTO Members as reflected in the text of the Article I Waiver was the following: pending the Article XXVIII GATT negotiations on the rebinding of the EC banana tariff, the EC's MFN tariff-quota concession continues to constitute the EC's bound commitments regarding bananas (AB Report, paras. 376–377).

72 AB Report, para. 386.

73 Such examination does not strike us as necessary, since the AB found the Doha Article I waiver not to be a subsequent agreement. Hence, the content of the Doha I waiver is irrelevant for this dispute.

74 AB Report, paras. 396–403.

concession would continue to constitute its scheduled commitments regarding bananas, pending the completion of the Article XXVIII negotiations.

We believe that the AB was right in finding that the Doha Article I Waiver was not a subsequent agreement on the interpretation of treaty provisions in the sense of Article 31(3) of the Vienna Convention. An extension of an MFN tariff quota clearly constitutes a temporary modification of the EC's Schedule of Concessions, and therewith by virtue of Article II:7 GATT, a modification of the covered agreements. However, this episode in *Bananas III* unveils a more systemic problem of the WTO, namely that temporary opt-out mechanisms are missing in the WTO (Schropp, 2009a).

The WTO is an incomplete contract among sovereign countries, where previously unforeseen contingencies or 'shocks' occur with a high probability (Horn *et al.*, 2009; Maggi and Staiger, 2008). Unforeseen shocks can give rise to 'regret contingencies' (Goetz and Scott, 1981), and all parties to the contract could benefit from letting the affected party temporarily 'escape', or 'opt out' of, the agreement, subject to an adequate compensation payment. The WTO knows several *de jure* emergency escape mechanisms, such as GATT Articles XVIII, XIX, and XX. However, enactment of those emergency relief mechanisms is exacerbated by significant levels of conditionality, which greatly reduces their usability.⁷⁵

In *Bananas III*, the AB held the view that 'if the duration of the tariff quota concession in the European Communities' Schedule had to be modified or extended, negotiations under Article XXVIII would be the proper procedure to follow'.⁷⁶ However, given the elaborate and extensive procedure entailed in Article XXVIII, the tool of tariff renegotiation is evidently not designed for urgent *temporary*, but for *permanent* deviations:⁷⁷ first, the procedure is excruciatingly complicated and thus renders emergency and temporary protection virtually

⁷⁵ The level of conditionality of an escape clause is composed of two elements: *Enactment thresholds* and *scope of application* (Schropp, 2009a). Enactment thresholds are contingency-related preconditions that the injurer has to surpass before making use of a flexibility mechanism. Enactment costs are sunk, and compensation payments do not form part of conditionality related costs. The second element of conditionality is the *scope of application*, the contractual deployment strings attached to the use of a trade-policy flexibility mechanism. The ease of use of a flexibility instrument is thus a function of the level of both conditionality and scope of application. As an example of how the level of conditionality can limit a trade flexibility tool, consider the safeguards clause under Article XIX GATT. For a safeguard measure to be imposed, an enacting country must show that 'i) as a result of *unforeseen development*; ii) imports in *increased quantities*; iii) have *caused* or threatened to cause; iv) *serious injury* to the domestic industry producing the v) *like product*' (see Mavroidis, 2007). Once the enacting country has jumped through that hoop, it can only invoke the safeguards measure exclusively in times of economic distress and apply such safeguard only once. Tariffs and QR are the only permissible trade instruments. The duration of safeguard measures is for a period of four years, although this can be extended up to eight years, subject to the findings of a mandated review panel (Article 7.1 SGA). In principle, safeguards cannot be directed at the country or set of countries that are the source of the injury (by virtue of Article 2.2 SGA). Instead, they have to be 'MFNed', that is applied on a non-discriminatory basis.

⁷⁶ AB Report, para. 395.

⁷⁷ Messerlin (2000: 162) contends that renegotiation under Article XXVIII is a disproportionate instrument for the aim of *temporary* protection.

impossible.⁷⁸ Second, tariff renegotiations are an untargeted, non-discriminatory measure. Tariff concessions must be offered by the demanding Member on an MFN basis, thus reducing its value as an efficient emergency relief. Third, strategic gamesmanship on the part of Members affected by the proposed tariff change make speedy conclusions rather unlikely. The affected Members hold a substantial bargaining power *vis-à-vis* the requesting Member, if they know that the latter is under a sizeable pressure to temporarily opt out of its previously made concessions.⁷⁹

In sum, whenever Members strive for temporary, transient, deviations from previously agreed concessions, the WTO legal framework proves slack and burdensome. In order to avoid that, Members make use of various *de facto* opt-out mechanisms (anti-dumping, anti-subsidy measures, breach of the agreement, voluntary export restraints, etc.); more flexible and user-friendly ways of compensated contractual escape should be found (Mahlstein and Schropp, 2007; Schropp, 2009a).

3.2.3 *Interpretation of the EC market-access commitments and expiry of the EC's 'MFN' tariff quota*

Given that the AB reversed the Panel's findings on the interpretation of the legal nature of the Article I Waiver, the AB was asked to consider Ecuador's conditional appeal on the interpretation of the EC's market-access commitments and the expiry of its MFN tariff-quota concession beyond 31 December 2001. Ecuador submitted that the Panel had erred in finding that the expiry of the Bananas Framework Agreement had automatically implied the termination of the EC's tariff-quota concession *vis-à-vis* all MFN exporters under the terms of its Schedule. Ecuador held that paragraph 9 of the BFA ('This agreement shall apply until 31 December 2001') did not establish an expiration date for the entire concession with respect to bananas. According to Ecuador, paragraph 9 rather established

⁷⁸ If the renegotiation request does not happen to fall into an official triennial renegotiation period of three months (laid out in GATT Article XXVIII.1), the injuring Member has to secure the prior authorization of *all* Members in order to enact its right to renegotiate (Article XXVIII.4). As per *Interpretative Note ad Article XXVIII GATT* (paras. 4.1, 4.4), the injurer must submit a written request to the Council of Trade in Goods, the relevant organ to decide. The requesting Member must supply comprehensive statistical and other information justifying its appeal and listing the effects of the envisaged measure. The Council will then give notice of its *consensus* decision within 30 days. *Interpretative Note ad Article XXVIII GATT* at para. 4.5 states that later on in the process the same Council determines – that is *all* WTO Members decide unanimously – whether the compensation offered by the injurer is sufficient. This sort of conditionality is certainly apt to slow down the process of reacting promptly to unforeseen contingencies and unanticipated shocks.

⁷⁹ Members with 'substantial interest' in exporting into the renegotiating Member have an incentive to hold out their counterpart. Knowing that time is precious for the Member seeking emergency relief, the affected Members may engage in opportunistic procrastination (foot-dragging) with the aim of influencing the *ex post* distribution of the resulting non-performance gains in their favor (cf. Fearon, 1998). This may result in either hold-out welfare losses and a 'blackmail-premium' for the victim, or even lead to an outcome in which the affected Member appropriates all the *ex post* gains from seizing the regret contingency.

expiry only of those terms and conditions in the BFA related to the renegotiation of quota shares (as Article XIII:2 requests Members to conduct). It thus argued that the EC's MFN tariff-quota concession remained in effect, and requested the AB to uphold the Panel's ultimate conclusion that 'the tariff applied by the European Communities to MFN imports of bananas set at €176/mt ... without consideration of the tariff quota for 2.2 million mt bound at an in-quota tariff rate of €75/mt, [is] in excess of that set forth ... in the European Communities' Schedule' and thus inconsistent with Article II:1(b) of the GATT.⁸⁰

In addressing Ecuador's appeal, the AB held as a preliminary issue that there are 'limits to the terms, conditions, or qualifications that may be incorporated in a Member's Schedule of concessions', but that the scheduling of temporal limitations to a tariff concession in the BFA was not incompatible with prior dispute-settlement findings. To determine whether the EC's tariff-quota concession *vis-à-vis* all non-ACP countries had really expired on 31 December 2001, the AB examined *all* relevant parts of the EC Schedule, including the column entries in Part I, Section I-B of the EU's Schedule and the BFA annexed to it under 'other terms and conditions'.

In Part I, Section I-B (entitled 'Tariff Quotas'), replicated above, the EC Schedule contains a tariff-quota concession of 2.2 million mt at €75 in Column 4 ('*final* quota quantity'). The BFA, referred to in Column 7 and annexed to the EC Schedule, repeats the in-quota amount and in-quota tariff (paragraphs 1 and 7), but states in paragraph 9: 'This agreement shall apply until 31 December 2002.' The AB claimed to give full meaning and effect to both the final tariff-quota concession in Column 4 and the temporary nature of the BFA referred to in paragraph 9, when it ruled that 'the Bananas Framework Agreement constitutes an agreement on the allocation, management and reallocation of country-specific shares within the "global basic tariff quota" referred to in paragraph 1. Therefore, we are of the view that the sentence "[t]his agreement shall apply until 31 December 2002" in paragraph 9 refers to an agreement on the allocation of shares.'⁸¹

The AB then turned to supplementary means of interpretation of the EC Schedule, specifically to the negotiating history of the EC tariff concessions and the BFA, the Uruguay Round 'Modalities Paper', the Doha Article I Waiver, and the EC request for tariff renegotiations under Article XXVIII. The AB largely found confirmation in its interpretation and concluded that the tariff-quota concession for 2.2 million mt bound at the in-quota rate of €75/mt remained in force beyond 31 December 2002 until the rebinding of the EC's Schedule of Concessions for bananas. Accordingly, the AB upheld the Panel's initial findings – albeit for different reasons – that the tariff applied by the EC to MFN imports on bananas, set at €176/mt, without consideration of the tariff quota of 2.2 million mt bound at an in-quota tariff of €75/mt was inconsistent with Article II:1(b) of the GATT.

80 AB Report, para. 412.

81 AB Report, para. 425.

The Modalities Papers used during the Uruguay Round negotiations expressly provide that they ‘shall not be used as a basis for dispute settlement proceedings’.⁸² The EC, accordingly, challenged the Panel’s use of the Uruguay Round Modalities Paper for agricultural market access as a means of supplementary interpretation. The AB disagreed with the EC.

The prohibition on the use of the Modalities Paper simply means, the Appellate Body said, that ‘it does not in itself confer on WTO Members’ rights and obligations enforceable in dispute settlement. However, this does not preclude references to the Modalities Paper when interpreting the WTO agreements and Members’ Schedules of Concessions that were prepared in accordance with these modalities.’⁸³

This statement was consistent with the Panel’s conclusion in *EC–Export Subsidies on Sugar* in which the EC had referred to that Modalities Paper as a supplementary means of interpretation.⁸⁴ However, in the *Sugar* dispute the AB had not found it necessary to rule on the relevance of the Modalities Paper.⁸⁵ In the present *Bananas III* dispute, however, the AB quoted with seeming approval the statement of the Panel in *Sugar*:

Clearly, the so-called Modalities Paper is not a covered agreement and thus cannot provide for WTO rights and obligations to Members. Nonetheless, it could be relevant when interpreting the Agreement on Agriculture, including Members’ Schedules.⁸⁶

This decision seems correct, but it does raise an issue concerning its possible impact on the – already tedious – negotiating process. Now that it is clear that preparatory documents, such as the Uruguay Round Modalities Papers, may be used as supplementary means of interpretation, despite their ‘shall not be used as a basis for dispute settlement proceedings’ language, agreement on modalities in current and future negotiations might become even more difficult to achieve.

4. A law and economics perspective on certain aspects of the AB Report in *Bananas III* (21.5)

In this section, we will examine the basic economics of tariff quotas and how different methods of tariff-quota administration can influence the distribution of trade. This will be followed by a discussion of the interrelationship between compliance Panels and arbitrations under Article 22.6 DSU.

⁸² AB Report, para. 442.

⁸³ Ibid.

⁸⁴ Appellate Body Report, *EC–Export Subsidies on Sugar*, para. 198.

⁸⁵ Ibid. para 199.

⁸⁶ Panel Reports, *EC–Export Subsidies on Sugar*, para. 7.350 (footnotes omitted), quoted by the Appellate Body Report in *Bananas III* (21.5) at note 517.

4.1 *Article XIII GATT and the economics of tariff quotas*

The AB upheld the Panel’s finding that the measure in question, the ACP preference, violates GATT Articles XIII:1 (on non-discriminatory *access* to tariff quotas), the chapeau of Article XIII:2 (non-discriminatory *administration* of tariff quotas), and Article XIII:2(d) (the ‘safe haven’ for tariff-quota administration based on historical quota allocation). Examining the economics of tariff quotas, we have three broader comments to make: first, given that tariff quotas in practice operate exactly like quantitative restrictions, their special status in the GATT is economically dubitable and can only be explained by the politics of multilateral negotiations. Second, the AB’s examination of the chapeau of Article XIII:2 can be seen as too cursory (and possibly flawed), depending on the interpretation of the non-discrimination counterfactual construed in that Article. Third, Article XIII:2(d) on historical quota allocation is an evident violation of the non-discrimination obligation in the chapeau of Article XIII:2. To wit, historical allocation of quota rights discriminates against the most efficient exporters and grants economic rents to less competitive producers. Such an outcome is in contradiction to the non-discrimination mandate enshrined in the chapeau of Article XIII:2. Even worse, nearly all quota-allocation mechanisms in practice today bear the inherent risk of discriminatory allocation of quota rights. Seen from an economic perspective, quota-right auctions comply with the strict non-discrimination standard set out in the chapeau of Article XIII:2. Transferable quota rights are another viable alternative of achieving a non-discriminatory distribution of trade.

4.1.1 *A brief economic assessment of tariff quotas*

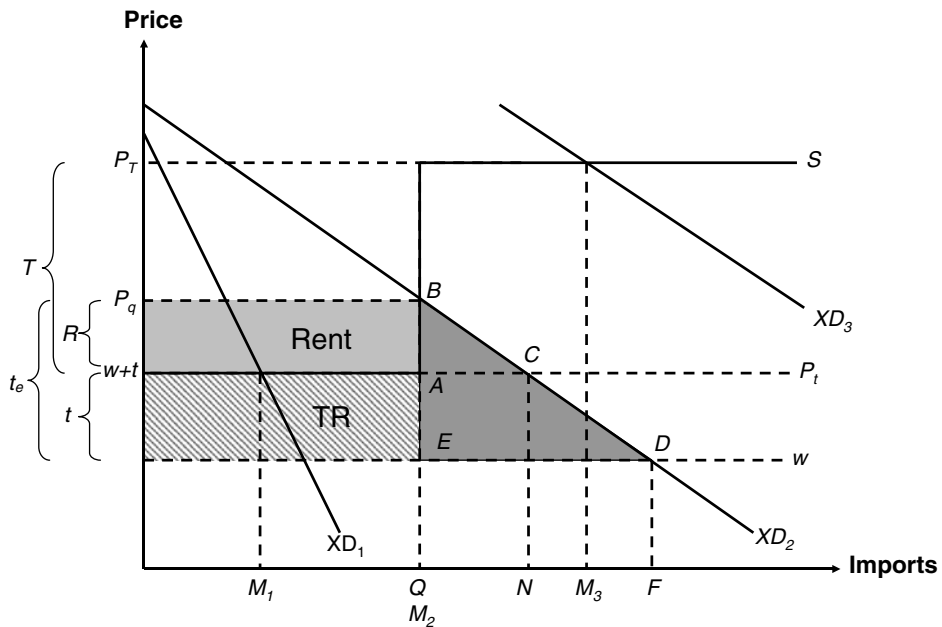
A tariff-rate quota, or tariff quota, is a two-tiered tariff, consisting of a lower *in-quota* tariff (t), applied to the first Q units of imports, and a higher over-quota tariff (T).⁸⁷ Tariff quotas are not considered quantitative restrictions, because technically they do not limit import quantities. Therefore, ‘tariff quotas do not fall under the prohibition of Article XI:1 and are in principle lawful under the GATT 1994’,⁸⁸ since exporters may always import by paying the over-quota tariff. The precondition, however, is that the tariff rates are applied consistently with the MFN tenet of Article I GATT, that in-quota and out-of-quota tariffs do not exceed bound tariff concessions (Article II GATT), and that the quota administration is in accordance with the disciplines of Article XIII GATT.⁸⁹ Yet, if the over-quota tariff makes it prohibitively expensive to import, the tariff quota yields the same import volume as a traditional quota.

⁸⁷ The terms ‘tariff quota’ and ‘tariff-rate quota’ are usually used interchangeably in the literature. Technically, ‘tariff quota’ is a more accurate description, because it includes specific tariffs, while tariff-rate quota excludes them.

⁸⁸ Appellate Body Report, para. 335.

⁸⁹ Article XIII applies to tariff quotas by virtue of Article XIII:5.

Figure 1. Tariff quotas and import demand



Source: Based on Skully (2001: Figure 5).

To see that, consider Figure 1, which illustrates the operation of a tariff quota. Imports are plotted on the x -axis, prices on the y -axis. For simplicity, the effective supply curve of exports (S) into the importing country consists of two horizontal lines. The lower line represents the in-quota imports and extends from zero to point Q at the price $P_t = w + t$, whereby w is the prevailing world price and t is the in-quota tariff rate. At Q the supply curve makes a vertical jump to connect in-quota with over-quota imports. The upper part of the supply curve represents the effective supply of over-quota imports at the price $P_T = w + T$, where T is the over-quota tariff.

The effect of a tariff quota on trade depends on the excess demand for imports. Figure 1 shows three possible excess-demand conditions (labeled XD_{1-3}). The intersections of XD_{1-3} with S fix three different import levels (points M_1 , M_2 , M_3). At XD_1 , the quota *tariff* is binding, meaning that domestic excess demand is M_1 , which is less than the quota volume Q . The tariff quota functions like an ordinary tariff applied at the in-quota rate. At M_2 , the tariff *quota* is binding and Q limits the supply available in the domestic market at a price P_q . With a binding quota, both domestic quantity is less and prices are higher than what would prevail if the tariff quota did not exist and only a tariff were applied at the in-quota rate of t (point N). Without any tariff, quantities would be demanded at the free-trade level of F . Excess-demand curve XD_3 , finally, represents a high

level of demand, sufficient to sustain imports at the over-quota tariff T . With a prevailing demand curve of XD_3 , T is binding, and M_3 units are imported.

Some observations about tariff quotas: first, tariff quotas are inefficient whenever the tariff quota is binding. At import quantity Q , less imports are available compared to a tariff-only regime (point N) and a free-trade regime (point F). This leads to economic deadweight loss compared to the tariff-only and free-trade scenarios (illustrated by the shaded triangles ABC and BED , respectively). Secondly, tariff quotas produce exporter rents, whenever the quota Q or the out-of-quota tariff T is binding. The economic rent is illustrated by the rectangle ABP_qP_t , denoted ‘Rent’. Third, whenever there are rents to be seized, imports must be rationed.⁹⁰ Rationing is the essence of tariff-quota administration (more on that below). Rationing is also at the core of additional inefficiencies, because (i) it allows otherwise non-competitive suppliers to export at a higher price and (ii) suppliers competing for rents may engage in wasteful activities, such as bribery.⁹¹

As our final observation, to take up a point made above, depending on the out-of-quota tariff T , a tariff quota acts exactly like a quantitative restriction, with the only exception that at least parts of the economic rents accrue to the importing government in the form of tariff revenues (hatched rectangle $AP_t wE$, denoted TR in Figure 1). In the original *Bananas III* dispute, the EC had an out-of-quota tariff of €680/mt of bananas. As was pointed out in footnote 4 above, this constituted a prohibitive tariff. Hence, the Original Banana Import Regime basically acted as a quantitative restriction, and therefore circumvented the obligations of Article XI GATT. The special status of tariff quotas is difficult to understand from a purely economic point of view, and is probably better explained by the political economy of the Uruguay Round negotiations.⁹²

⁹⁰ In case that excess demand XD_2 is prevailing, N units of potential supply must be rationed among Q units of demand.

⁹¹ We note that the WTO is not concerned with the volume and distribution of *rents*, but solely with the volume and distribution of *trade*. However, as will become clear in the next section, the distribution of rents has a significant impact on the distribution of trade, not least because the distribution of rents motivates the politics of tariff-quota administration.

⁹² Many pundits argue that the tariffication of existing quantitative restrictions and the ‘minimum access’ obligation pursuant to the Uruguay Round have not led to a noticeable increase in trade, because WTO Members used new tariff quotas to maintain traditional import flows. This can be explained by several factors. First, as mentioned, the Modalities Paper was not incorporated into the Single Undertaking. As a result, the Modalities disciplines were left to the discretion of individual countries and thus were not always followed in practice. Secondly, tariff quotas were often set for products characterized by tariff peaks, so the out-of-quota tariffs remain prohibitive. Third, the management of tariff quotas is incoherent among Members and highly intransparent. Fourth, countries employed various tricks to circumvent the tariffication obligation (for example, by allocating quotas to countries that are unlikely to export the relevant commodity). Finally, the way Members administer their tariff quotas has a large role on the so-called quota fill (IATRC, 2001: 2).

4.1.2 *The distribution of trade under tariff quotas and the AB's test of Article XIII:2*

The chapeau of Article XIII:2 of the GATT reads in pertinent parts:

In applying import restrictions to any product, contracting parties shall aim at a distribution of trade in such product approaching as closely as possible the shares which the various contracting parties might be expected to obtain in the absence of such restrictions ...

This language implies the construction of the following counterfactual: how would the world look *in the absence of such restrictions* – in this case, in the absence of a *tariff quota*? The distribution of trade under this counterfactual shall then be used to compare the actual distribution of trade under the tariff quota to check for possible discrimination against exporting countries.⁹³ Yet, Article XIII:2 does not state which counterfactual is pertinent. There are potentially three plausible counterfactuals implied by Article XIII:2: (i) a free-trade counterfactual, that is a situation that would exist absent *any* import restrictions; (ii) a tariff-equivalent counterfactual, that is a situation in which the same quantities were imported as in the presence of an in-quota tariff only; and (iii) a quota-equivalent counterfactual in which the imported quantities were limited in the same way as under the quota at issue. As will be argued below, each of these three counterfactuals could potentially be compliant with the MFN principle.

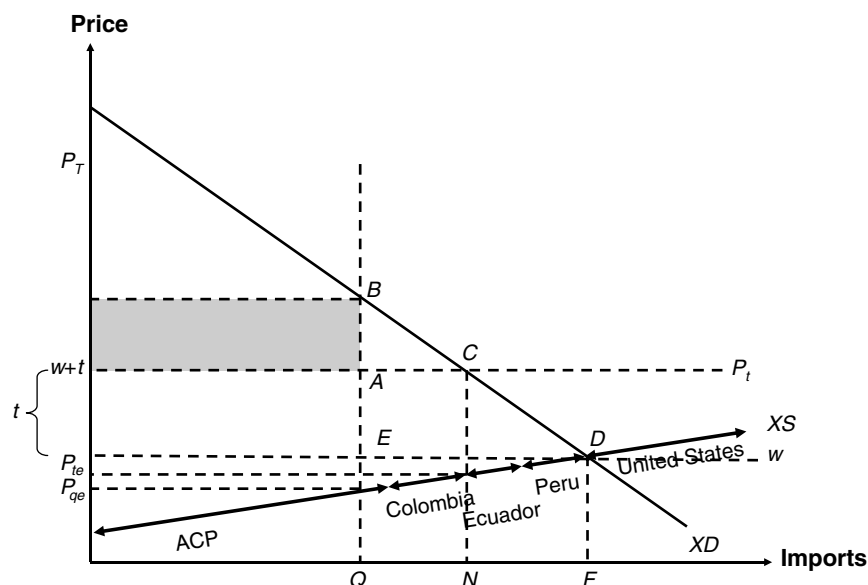
To see how these three counterfactuals differ, consider Figure 2, which is a slight variant of Figure 1, this time with an upward-sloping excess-supply curve (XS). The world price w is fixed where excess-demand and excess-supply curves intersect, setting a free-trade quantity of F . If the in-quota tariff were applied in the absence of the quantitative restriction, domestic consumers would demand a quantity of N units. Under a quota-equivalent counterfactual, the importing government would import the same quantity as under the quota (Q).

Importantly for the *Bananas III* case at hand, those three counterfactual scenarios involve substantially different distributions of trade. If trade were completely unrestricted, suppliers inframarginal to world price w would be willing to export to the domestic market.⁹⁴ The composition of this group of suppliers, that is their export shares, would then be the basis for a non-discrimination test under Article XIII:2. In the tariff-equivalent counterfactual, where the imported quantity were limited to N units, only suppliers inframarginal to a fictitious price P_{te} would be willing to export their goods to the importing country. The composition of suppliers in this second scenario could potentially differ, because suppliers inframarginal to w , but extramarginal to P_{te} , would drop out of the relevant MFN supplier group. Even fewer suppliers, namely only the most competitive ones,

⁹³ Basically, a pie chart of exporter market shares under a non-discriminatory tariff quota should look identical to the pie chart in the absence of such quota, just with the second pie being smaller (Skully, 2001).

⁹⁴ The word *inframarginal to price x* essentially means 'fit to compete at a price x in market Y '.

Figure 2. Three interpretations of the counterfactual construed in Article XIII:2



Source: Based on Skully (2001: Figure 5).

would manage to export, if quantity was limited according to the quota-equivalent counterfactual (quantity Q at a fictitious price P_{qe}). The group of suppliers and therewith counterfactual export shares will again differ from the other two scenarios.

Figure 2 lists a hypothetical group of competing importers of bananas and stacks them in their order of competitiveness, that is according to their (hypothetical) cost of production.⁹⁵ Imagine for the sake of argument that ACP countries were the most competitive suppliers, followed by Colombia, Ecuador, Peru, and the United States. Imagine now that the zero-tariff quota would be quite small, e.g. 10,000 mt of bananas.

Depending on the counterfactual chosen, a discrimination examination under Article XIII:2 yields strikingly different results. Under the free-trade scenario, all exporters except the United States would export to the country at issue. All those exporters should thus be granted a certain in-quota share. Under the tariff-equivalent counterfactual, Ecuador and Peru would drop out of consideration, and

⁹⁵ The excess-supply curve in Figure 2 is the linear combination of excess-supply curves of exporting countries. More competitive suppliers (like Colombia) would thereby have steeper domestic excess-supply curves than would less competitive countries (such as the US in our fictitious example).

in-quota trade should be distributed among ACP members and Colombia only. Finally, taking the quota-equivalent counterfactual as the legal benchmark, a quota allocation to ACP countries would be fully justified.

The AB in its Report justified the EC's violation of Article XIII:2 with the following words:

The tariff quota also fails to meet the requirements regarding distribution and allocation in Article XIII:2. The exclusion of non-ACP suppliers from the tariff quota is not aimed 'at a distribution of trade ... approaching as closely as possible the shares which the various Members might be expected to obtain in the absence of [the] restrictions', as required by Article XIII:2. *On the contrary, the exclusion of non-ACP suppliers is not aimed at a distribution of trade that affords access to, and competitive opportunities under, the tariff quota to all supplying Members reflecting their comparative advantage ... Allocating the entire tariff quota exclusively to ACP countries, and reserving no shares to non-ACP suppliers, cannot be considered to be based on the respective shares of ACP and non-ACP supplier countries in the European Communities' banana market.* As a result, the exclusion of non-ACP suppliers from the tariff quota of 775,000 mt reserved for ACP countries is inconsistent with the requirements ... the chapeau of Article XIII:2.⁹⁶

We submit that we believe the AB's finding to be correct in substance. However, in the light of the above, the AB's analysis could be seen as slightly too cursory, because the AB did not state which counterfactual it applied in reaching its finding, and what the competitive position of ACP suppliers really is, as compared to their competitors. The EU could have argued for the quota-equivalent counterfactual and asserted that ACP countries are the only banana suppliers inframarginal to a hypothetical price of P_{qe} .⁹⁷

4.1.3 *Quota-allocation methods, distribution of trade, and the inherent contradictions in Article XIII:2 GATT*

As the title suggests, Article XIII regulates the non-discriminatory administration of, inter alia, tariff quotas. The AB has opined that Article XIII:2 extends the MFN principle to quota allocation, an interpretation to which the authors of this comment agree.⁹⁸ The principle of non-discrimination among all exporting Members asserts that trade shares should be determined by the relative efficiency of suppliers, but not by alternative, discriminatory criteria. The methods with which tariff quotas are allocated among different countries have a significant impact on

⁹⁶ AB Report, para. 340 (emphasis added).

⁹⁷ An interpretation of Article XIII:2 that champions a quota-equivalent counterfactual, however, is not watertight. After all, why should exporters offer their imports at price P_{qe} if they could receive a much higher price w on the world markets?

⁹⁸ See footnote 68 and accompanying text.

the distribution of trade. WTO Members have notified at least six distinct allocation methods for their tariff quotas:⁹⁹

- applied tariffs,
- auctions,
- license on demand (LoD),
- first-come, first-served (FCFS),
- historical allocation (HA), and
- discretionary allocation (either through state-trading enterprises or through producer groups),

whereby applied tariffs and auctions can be grouped together as ‘market allocation’ methods, while LoD, FCFS, and HA can be categorized into the broad group of ‘quasi-market allocation’ methods.

As will be argued below, only truly market-based allocation methods, namely applied tariffs, quota auctions, and markets for quota-rights resale satisfy the principle of distributive justice among WTO Members, while the design of all other methods is inherently discriminatory against the most competitive suppliers.¹⁰⁰ Notably, historical allocation, the so-called ‘safe haven’ mentioned in Article XIII:2(d), is inherently flawed and therewith contradicts the chapeau of Article XIII:2.

4.1.3.1 Market allocation methods

Notifying *applied tariffs* is just another way of saying that the tariff quota is not enforced, and that all imports are allowed at preferential in-quota tariff rates. The resulting distribution of trade is non-discriminatory, because the tariff quota acts just like a tariff (see demand curve XD_1 in Figure 1).¹⁰¹ Applied tariffs do not address the problem of having to ration tariff-quota shares among competing exporting Members. We hence do not consider this method further.

The *auctioning of tariff-quota rights* is generally deemed to be an efficient way to allocate the right to export amongst competing exporters (Bergsten *et al.*, 1987; Skully, 2001; Skully, 1999). For the following elaborations, consider again Figure 1. Auctions neutralize quota rents (R), and mimic the allocative outcome of a tariff-only scenario, in which a tariff equivalent t_e would be applied. In the absence of the tariff quota, exporters inframarginal to the world price w would be willing to import. The presence of a binding quota invites less competitive suppliers, namely those that are extramarginal to w , but inframarginal to P_q , into the importing market, because the prevailing domestic price allows these higher-cost suppliers to stay in the market, and possibly to capture some of the rent R .

⁹⁹ Members must notify the WTO about how they administer tariff quotas in their Tariff Schedules.

¹⁰⁰ However, it is not certain whether quota auctions are GATT conforming. In addition, they are politically difficult to enact. These issues will be discussed in subsection 4.1.3.5 *infra*.

¹⁰¹ Over half of all notified tariff quotas are not enforced (Skully, 1999: 8). However, the over-quota tariff can be reapplied at will, which injects a certain level of incertitude for foreign exporters.

In an auction, suppliers have to bid for the right of supplying the importing market. The most competitive suppliers are willing to pay approximately $R = P_q - (w + t)$ for the opportunity to sell at the price of P_q and to make a riskless profit of R per unit sold. Exporters extramarginal to the world price w will be outbid by these inframarginal suppliers. The importing government realizes gains from trade equal to the auction revenue R plus the in-quota tariff t . This allocation is exactly identical to the one that would result from the tariff-equivalent of a tariff quota t_e .

4.1.3.2 Quasi-market allocation methods¹⁰²

License on demand (LoD), first come, first served (FSFS), and historical allocation (HA) are a mix of market allocation and a random lottery among certain exporters. All three methods result in discriminatory allocation of quotas; in the best case, their results match that of an auction, but such an outcome would be purely coincidental.

Under *License on demand*, exporters are invited to apply for licenses at the beginning of a given quota period, specifying the quantity of imports they would like to carry out. If domestic demand is sufficient, the quota binds. The sum of all quota requests is denoted as Q^* . With $Q^* > Q$, the quota binds. To ration export licenses, every bidder's application quantities are reduced proportionally by factor λ , so that $Q = \lambda Q^*$, whereby λ is a rationing factor, and $0 < \lambda < 1$ holds.

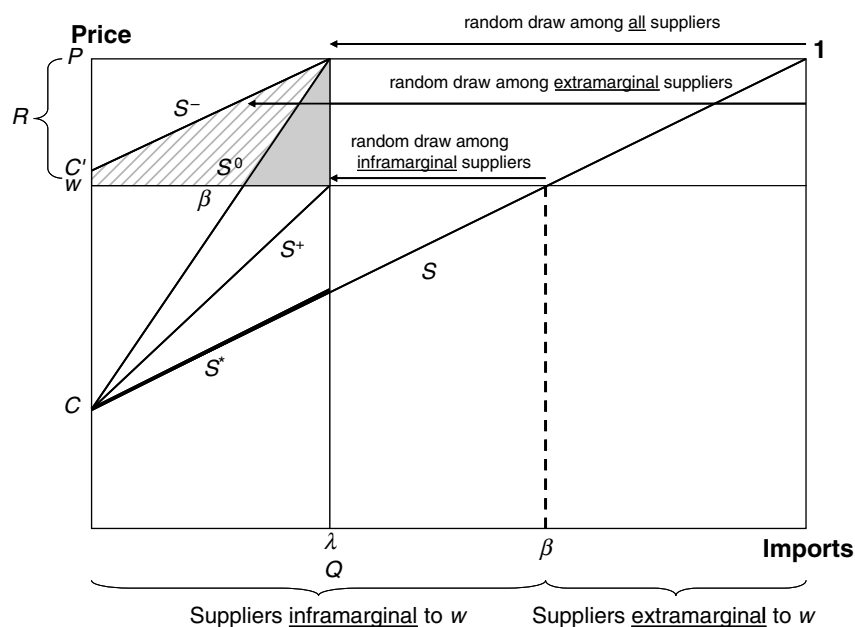
This tariff-quota administration method is very likely to produce a biased distribution of trade that violates the non-discrimination tenet of Article XIII:2 GATT. Consider Figure 3, which shows the supply side of imports. The domestic price is P , the world price w , and the unit quota rent is $R = P - w$. S is an upward-sloping supply curve of imports into the country at issue.¹⁰³ The area under the supply curve represents payments to factors employed to the product at issue. Exporters extramarginal to w must spend resources in excess of w to produce a unit of output. Hence, extramarginal production destroys value; extramarginal suppliers would not be able to import under free-trade conditions.

LoD allocation is a form of lottery among all exporters inframarginal to the domestic price P (that is, inframarginal and extramarginal suppliers alike). They all have an incentive to enter into the quota lottery to capture some of the riskless quota rent R . Rational applicants, cognizant of the rationing, have an incentive to overstate their license requests. Thus, quantity applied for exceeds the in-quota supply: $Q^* = 1 > Q = \lambda$. To deal with quota oversubscription, each applicant is granted a pro rata share of the global quota. The effective supply curve under the tariff quota thus skews leftwards (S^0), to reflect the random draw among all

¹⁰² The following analysis of tariff-quota allocation methods borrows heavily from Skully (2000) and Skully (2001).

¹⁰³ To reduce clutter, Figure 3 assumes an in-quota tariff of zero, a prohibitive out-of-quota tariff, and that the domestic market clears at P . Domestic price P and free-trade quantity I are normalized to 1.

Figure 3. Tariff-quota allocation methods



Source: Based on Skully (2001: Figure 5).

suppliers inframarginal to P . The proportion of quota rights granted to exporters inframarginal to w is β the proportion of competitive free-trade suppliers. LoD allocation causes the displacement of $\lambda(\Lambda - \beta)$ inframarginal suppliers by extramarginal suppliers, *who would not have supplied the import market under free trade*. Hence, the expected distribution of trade differs from the free-trade counterfactual, which consists uniquely of inframarginal suppliers. The welfare loss from LoD allocation is shown by the shaded triangle to the right of S^0 . The loss of welfare can be interpreted as an indicator of how the expected distribution of trade under LoD differs from the tariff-equivalent counterfactual distribution of trade.

First-come, first-served allocation allows importation at the in-quota tariff until the quota is filled. To analyze the distribution of trade under FCFS, some assumptions must be made about the correspondence between an exporter's willingness to supply and his place in the FCFS queue.¹⁰⁴ We examine four scenarios: (a) an optimistic scenario in which the lower-cost exporter is always placed ahead of the less competitive supplier; (b) a realistic scenario in which the otherwise uncompetitive higher-cost supplier queues before the competitive exporter; and

104 FCFS can lead to a 'run to the docks', which introduces a host of further inefficiencies that shall not be examined here, such as transaction costs from shipments waiting idly in front of the docks, processing bottlenecks, redundancy back-up shipments, etc.

two intermediate scenarios in which (c) there is a zero correlation between cost and place in the queue and (d) there is a positive, but imperfect relationship.

Consider first scenario (a): the lower-cost exporters are always placed ahead of less competitive exporters; then the effective quota supply curve is exactly the original supply curve S in the interval $(0, \lambda)$. Call this segment of the S -curve S^* . However, because competitive suppliers can easily sell on the world markets at w , the world price becomes the lower bound on their willingness to supply the import market. Assuming that each inframarginal supplier is equally likely to supply the import market, a random drawing from the set of inframarginal suppliers is the result, yielding the effective quota supply curve S^+ . Under this allocation, efficient discrimination between inframarginal low-cost and extramarginal high-cost exporters is achieved and the tenet of non-discrimination is adhered to. Yet note well that this scenario presupposes a *perfect* correlation between competitive rank and place in the queue. Such an outcome, if it ever happens, is very unlikely.

Consider the opposite situation, scenario (b), in which the highest-cost suppliers undertake efforts – and succeed – in queuing before low-cost suppliers.¹⁰⁵ When low cost of production is inversely correlated with the position in the queue, the expected outcome may be represented by the supply curve termed S^- , in the far-left corner of Figure 3 (S^- is a leftward shift of the extramarginal segment of curve S). From a welfare perspective, but also from a non-discrimination point of view, such an outcome is unwelcome, since all those inframarginal suppliers, who would have supplied the import market in the absence of the tariff quota, are crowded out by high-cost exporters. A completely biased distribution of trade is the result.¹⁰⁶

Next, consider scenario (c) a zero correlation between cost and rank in the queue. As was discussed previously under the LoD allocation method, a random selection of inframarginal (competitive) and extramarginal (non-competitive) suppliers from a population uniformly distributed over the interval (C, P) has the expected distribution represented by the supply curve S^0 .

Finally, an FCFS process with a positive, but imperfect, correlation (scenario (d)), will yield an expected allocation of quota rights between S^0 and S^+ over the range $(0, \lambda)$. Hence, some expected inframarginal displacement will occur in this case of positive but imperfect correlation too, whereby the lower the correlation between low cost and rank in the queue, the greater the expected displacement (the closer the actual supply curve will be to S^0).

In sum, a tariff-quota allocation method of FCFS will lead to a displacement of between none and all inframarginal suppliers, depending on the correlation between comparative advantage and place in the queue. Even if there is a zero

¹⁰⁵ Such scenario with a negative correlation between cost and place in the queue is not entirely unrealistic: Otherwise non-competitive exporters will make extra efforts to tap rent-laden markets; presumably, these are the only markets in which these extramarginal producers can sell at all. So, they specialize in securing pole position in the ‘run for the docks’ that the FCFS allocation triggers.

¹⁰⁶ The area below S^- in the range $(0, \lambda)$ represents wasted resources and thus welfare loss (the sum of the hatched and shaded planes in Figure 3).

correlation (an unrealistically optimistic suggestion), a fraction of $\lambda(\Lambda - \beta)$ inframarginal suppliers will get crowded out by otherwise uncompetitive producers.

Historical allocation finally can be viewed as an extreme variant of an FCFS or LoD allocation. Whereas FCFS and LoD are annual lotteries, historical allocation of quota shares is essentially a one-time-only draw. A particular realization is sustained for many years and remains invariant to changes in underlying market conditions. Examining the US sugar import regime ever since 1934, Skully (1998) shows that quota rights for US sugar imports have undergone major reallocations every 15 years only.¹⁰⁷

Bown and McCulloch (2003), in an empirical study dealing with safeguard protection, show that (tariff) quotas preserving historical market shares discriminate among foreign suppliers, as compared to safeguards implemented by simple tariffs (a regime that maintains the comparative advantage of suppliers). The authors empirically prove that safeguards implemented through quantitative restrictions (HA) discriminated against suppliers whose market shares had been growing over the ‘representative period’ leading up to the quota, in favor of suppliers whose share had been declining.¹⁰⁸ They conclude that ‘quota and [tariff quota] safeguards used to protect domestic suppliers may also provide some relief to established trading partners whose positions in the relevant import market have been adversely affected by increased competition from other import sources’.¹⁰⁹

To sum up our findings on quasi-market allocation mechanisms for tariff quotas: Auctions, LoD, and HA are all special cases of a general FCFS process. An auction is equivalent to a FCFS allocation with *perfect* correlation between competitive situation and rank in the queue (curve S^+ in Figure 3), LoD is equivalent to a random FCFS process with a *zero* correlation between cost and place (supply curve S^0), and HA is a ‘sticky’ random FCFS allocation somewhere between the S^* and S^0 curves. All allocation methods, except tariff-quota auctions, inherently discriminate against those competitive (inframarginal) suppliers that would divide up the import market amongst themselves in the absence of a tariff quota.

107 Taiwan has a historical tariff quota share of 24,000 short tons of sugar into the United States. Taiwan always fills that quota. However, this is the only sugar Taiwan exports; the country’s production does not satisfy domestic demand. The 24,000 short tons of domestic sugar exported to the US are sourced cheaply from Australia or Thailand (IATRC, 2001: 74).

108 The logic here is straightforward: ‘Consider two exporting countries, A and B, with opposite trends in market share for the good whose domestic suppliers are about to be protected by a safeguard. In the three years prior to the year the [quota] is imposed (year t), country A’s market share has fallen from 15 per cent in year $t-3$ to 10 per cent in year $t-2$ to 5 per cent in year $t-1$. Under a ... quota, allocation of market shares based on the average of historical levels would reward A with a 10 per cent market share in year $t+1$, twice its actual share in the year before the safeguard was imposed. On the other hand, B’s market share has risen from 5 per cent in $t-3$ to 10 per cent in $t-2$ to 15 per cent in $t-1$. Under a safeguard quota with allocation of market shares based on average historical levels, B’s market share would drop to 10 per cent in $t+1$, one-third less than it achieved in the final year before the safeguard was imposed’ (Bown and McCulloch, 2003: 332).

109 *Ibid.*, p. 337.

4.1.3.3 Discretionary allocation methods

Discretionary methods of tariff-quota allocation delegate quota administration and allocation processes to domestic groups or organizations, for example state-trading enterprises (STE) or certain organizations that represent producer interests. How STE or producer groups go about allocating the quota rights remains within their discretion. Usually, they fill quotas depending on domestic demand. It is difficult to generalize discretionary allocation methods, because they cannot be reduced to formal algorithms, but instead are subject to certain domestic decision processes. Anecdotal evidence from case studies leads to the conclusion that discretionary methods are often divorced from commercial considerations and open for political strategizing, personal enrichment, and nepotism.¹¹⁰ The Panel report in *Turkey–Rice* has shown just how intransparent such discretionary quota-allocation methods can be.¹¹¹

4.1.3.4 Article XIII:2(d) GATT and historical allocation

Article XIII:2(d) on HA of tariff quota states:

In cases in which a quota is allocated among supplying countries the contracting party applying the restrictions may seek agreement with respect to the allocation of shares in the quota with all other contracting parties having a substantial interest in supplying the product concerned. In cases in which this method is not reasonably practicable, the contracting party concerned shall allot to contracting parties having a substantial interest in supplying the product shares based upon the proportions, supplied by such contracting parties during a previous *representative period*, of the total quantity or value of imports of the product, due account being taken of any *special factors* which may have affected or may be affecting the trade in the product. (emphasis added)¹¹²

Article XIII:2(d) nominally allows Members to transfer and reallocate tariff-quota rights among exporting countries, in line with changing economic and competitive conditions, according to the free-trade counterfactual during a ‘representative period’. If countries actually made use of this possibility, this would greatly reduce the risk of a biased distribution of trade and substantially mitigate discriminatory allocation of tariff-quota shares. However, even after some careful study, the authors are unaware of a single case where uncompensated reallocation among quota holders occurred in accordance with Article XIII:2(d), first sentence.

110 See IATRC (2001: chapters 8 and 9); see also Skully (1999: 16–19).

111 See Gantz and Schropp (2009).

112 The two italicized terms have been subject to further definition in a series of Interpretative Notes to Article XII. With respect to *representative period*, the convention is to use a three-year period prior to the imposition of a restriction, where possible. Regarding *special factors*, it is noted that this term includes, among others, (i) changes in relative productive efficiency between foreign producers; (ii) the existence of new or additional ability to export; (iii) reduced ability to export.

The lack of such reallocations can be explained by the technical difficulties of constant reallocation of quota shares, and by the political economy of tariff quotas.

Under permanent reallocation of quota shares, the importing government reassesses on a rolling basis the competitiveness of all foreign exporters and accordingly reallocates shares at the beginning of every period. However, doing so presupposes quite a high level of sophistication and information on the part of the importing government. And there is no reason to believe that bureaucracies, even in the most advanced countries, have the means to constantly ‘outsmart’ the market. Abstracting from the significant costs of such endeavor, individual mistakes, slackness, corruption, and incompetence could potentially foil such government-induced constant allocation from the start.

Looking at the political economy of tariff-quota allocation, one primary reason why importing governments allocated exporter quotas in the first place was to appease suppliers harmed by the imposition of the quota.¹¹³ Tariff quotas thus were used in a fashion very similar to voluntary export restraints (VER). Highly competitive countries ‘voluntarily’ reduce their exports in exchange for quota rents. What was initiated as compensation to otherwise competitive exporters over time turned into an entitlement. Once foreign exporters are vested with quota rights, a proposed (uncompensated) reallocation of shares will presumably upset them and spark vivid threats and politically harmful responses against the importing Member.

In summary, evidence shows that HA as an allocation method seriously biases the distribution of trade and discriminates against those exporters that would have seized large import shares in the absence of such tariff-quota allocation: First, unless historical shares were initially auctioned off, chances are high that their original allocation did not reflect the free-trade allocation of shares.¹¹⁴ Second, unless HA is not continuously updated and redistributed, it will cement an outdated situation that does not reflect accurately the current competitive situation.¹¹⁵

Hence, HA as a distributive principle is very likely to discriminate against the most competitive suppliers and therefore, by nature of the political economy of its operation, violates the chapeau of Article XIII:2, which mandates a non-discriminatory allocation of tariff-quota shares. Hence, ironically, Article XIII advocates both non-discrimination *and* discrimination at the same time.¹¹⁶

113 Bown and McCulloch (2003, footnote 11) explain the political economy of quota allocation in cautious terms: ‘A possible justification for the discriminatory treatment is that traditional suppliers have “paid” for their market access with their own earlier concessions, while newer entrants have not. In fact, newer entrants are often also new to the GATT/WTO system.’

114 As the analysis in the previous subsection showed, if historical shares were initially allocated according to a FCFS or LoD system, distribution was biased *ab initio*.

115 The IATRC (2001) report on tariff quotas, chapters 5–11, contains a number of case studies, including tariff quota regimes under HA.

116 See Hudec (1997: 178 *et seq.*).

Article XIII:2(d) in essence is not a ‘safe haven’, but a legally available tool of discrimination.

As was shown above, the same goes for almost all other allocation methods, namely license on demand, first come, first serve, and discretionary methods. They lead to a biased distribution of trade, displacing a good number of competitive (inframarginal) exporters that would have secured significantly bigger market shares under the free-trade counterfactual.

4.1.3.5 Ways of making quota allocation compatible to Article XIII:2 GATT

We now turn to three alternative methods of tariff-quota administration to see whether tariff allocation can be compatible with the chapeau of Article XIII:2 GATT at all. These three methods are: active government involvement, tradable quota rights, and quota auctions.

A first option of safeguarding a non-discriminatory quota-allocation regime is active government involvement, either in the form of a permanent reallocation of tariff-quota shares, or in the form of continuous tariff setting. We have discussed the logistical and technical problems of constant quota reallocation in section 4.1.3.4 above. As an alternative, tariff quotas can be actively administered by constantly setting import tariffs, and therewith domestic prices. As was discussed above, government action could bring about imports equal to the quota quantity Q by increasing the in-quota tariff such that the import tariff dissipates all economic rents to quota holders (that is, by having a quota-equivalent tariff equal to $t_e = P_q - w$ in Figure 1). However, such tariff management poses at least two problems: for one, exact knowledge of domestic excess-demand elasticity and other market information is indispensable for determining the correct tariff rate. Also, market conditions can change quickly, so that tariff rates need to be updated continually. Both factors most probably overburden any – even highly developed – bureaucracy.

A second option for achieving an unbiased distribution of trade under a tariff quota is to establish a resale market for tariff-quota rights. When tariff-quota rights are non-transferable, the entitled country must produce and export the good to realize the quota rent. This will motivate extramarginal producers to export, even though under a free-trade scenario they would not do so.¹¹⁷ Hence, non-transferability of quota rights ties the distribution of *rents* to the distribution of *trade*. Allowing quota rights to be traded unties this connection between rents and actual trade patterns. Resale of tariff-quota rights can help avoid the incidence of deadweight loss caused when extramarginal suppliers are displacing competitive inframarginal producers. Neglecting information gathering and transaction costs for a moment (and assuming economic agents are rational), extramarginal quota

¹¹⁷ As was shown in footnote 107, some quota holders produce and export only to fill their quota and pocket the quota rents, but then end up importing from cheaper sources. Such an outcome is economically wasteful.

holders should be willing to sell their quota rights to those exporters that are competitive on the world markets. Such trades should be expected to occur at a price R per unit, the amount equal to the quota rent or the marginal auction bid. Since extramarginal quota holders value the quota rent at R or less (depending on their own cost structure), while inframarginal suppliers value the right to export at R or more (depending on their level of competitiveness), a liquid market for quota rights should be easily established.

From the point of view of the WTO, the only relevant consideration is the distribution of *trade*; the allocation of *rents* is irrelevant per se. With quota resale allowed, the final distribution of trade is equivalent to that under free trade, under accurate yearly reallocation, under quota-equivalent tariffs, and under auctions. The only difference is that quota rents are captured by the initial quota holders, not by the importing government.

Markets are the most efficient way of rationing scarce supplies and demands. The third option of tariff-quota allocation is to directly use the market mechanism, and to auction off quota rights. Tariff-quota auctions should be the most favorite option to economists, because the allocation mechanism is swift and efficient. In addition, auctions cannot be rigged easily; the most competitive producer gets rewarded, thus stimulating suppliers to become ever-more efficient.

Yet, tariff auctions are rarely applied.¹¹⁸ If tariff-quota auctions are so perfect, why are they in such little use? We find economic, political, and WTO legal reasons.

Economically, tariff-quota auctions require markets that are sufficiently liquid, that is possess a large volume of trade and a high number of competing bidders. If this is not the case, auctions can lose some of their appeal to policymakers. Another concern is monopolization: it is possible for one exporter or group to purchase the entire portion of the right to import, and then withhold part of the licensed-import quantity to maximize revenues.¹¹⁹

There is also a *political explanation* for the low number of tariff-quota auctions in use today. Auctions are markets and as such hard to control. If the administering government prefers to transfer quota rents to certain countries (VER-style) rather than collecting rents as auction revenue, it will decide not to auction off the quota rights. Presumably, such zeal was guiding the EC in its Banana Import Regime.

Finally, there may be *WTO-legal* reservations against utilizing tariff-quota auctions.¹²⁰ One argument against auctioning import rights runs as follows: under Article II GATT, countries schedule their maximum tariffs. By auctioning off

118 According to Skully (1999: 8), only 4% of all tariff quotas notified in 1999 came out of auctions. More up-to-date information on tariff quotas can be obtained on the WTO website (http://docsonline.wto.org/gen_home.asp?language=1&c_=1) (last visited 19 November 2009). Most tariff quotas bear the code G/AG/N/member.

119 However, Bergsten *et al.* (1987) argue that simple procedures can be designed to guard against this monopolization of quota rights.

120 This section draws on insights gathered from Skully (1999).

quota rights, exporting countries may bid in excess of the tariff ceiling, thus potentially violating the tenets of Article II:1(b) and affording a greater protection than previously afforded.

A Member could argue that auctioned importing rights effectively paid by its exporters, *de facto* amount to an increase in the importing Member's bound rate. As an important preliminary issue: who is granted the quota – the importer or the exporter? If a quota-imposing Member grants an export quota to other Members, then the exporters seize the economic rent and there would likely be less of a legal problem. With import quotas, however, the importers are entitled to the quota rents. A tariff-quota auction paid for by exporters could then, arguably, be considered an increase in the level of protection. This interesting legal issue is left to future research.

From an economic perspective, however, a violation of Article II:1(b) seems less problematic and easily deflated. Auctions only change the allocation of quota *rents* (a circumstance to which the WTO should be indifferent), but not the *volume* of trade, which essentially remains the same. The unit rent is simply absorbed as auction revenue instead of being captured by quota holders.

Another argument against quota auctions is that auctions may constitute an extra fee on imports in violation of Article VIII:1(a).¹²¹ Again, from an economic point of view, no additional protection is afforded to domestic products. Also, one may argue that the importing government, as the creator of the initial restriction to trade, may have a prior claim to the rents thereof. It may *choose* to transfer these rents to foreign suppliers for free (e.g. under a FCFS allocation method), but exporting countries have no actionable *right* to such rents. Since the WTO has nothing to say about the entitlement to economic rents, auctioning quota rights could thus be interpreted simply as a tool for the importing country to change the market value of the financial asset transferred.

From a legal point of view, things may seem less straightforward. It could be argued that, by auctioning quota rights, foreign producers who have invested heavily in building up an export market and created tangible goodwill, *de facto* get expropriated if their auction bid is not successful.¹²²

A final concern about quota auctions we can think of could be that auction revenue constitutes taxation for fiscal purposes. Most tariff quotas were constructed in the aftermath of the Uruguay Round to replace import quotas. True,

¹²¹ Article VIII:1(a) reads: 'All fees and charges of whatever character (other than import and export duties and other than taxes within the purview of Article III) imposed by contracting parties on or in connection with importation or exportation shall be limited in amount to the *approximate cost of services rendered and shall not represent an indirect protection to domestic products or a taxation of imports or exports for fiscal purposes*' (emphasis added).

¹²² Palmeter (2003: 100–103) argues that the introduction of certain US quota-auction schemes discussed in the United States would effectively have expropriated exporters, destroying their prior investments in marketing and customer relations, while depriving them of their right to choose their customers (the license holder).

these former quotas did not generate revenue; they simply provided domestic protection and transferred rents to select participants. However, since the motivation for tariff quotas was to replace harmful quantitative restrictions, neither the objective, nor the effect of original quotas (and their tariff-quota equivalents) was the generation of tax revenue for fiscal purposes. In addition, the auctioning of tariff-quota rights, albeit creating revenues, is required by the transfer of rights to riskless rent in an amount largely equivalent to the auction price.¹²³

To summarize, nearly all conventional methods of tariff-quota allocation are inherently discriminatory, and are thus in violation of the chapeau of the MFN principle articulated in the chapeau of Article XIII:2 GATT. To mimic the non-discriminatory free-trade equivalent distribution of trade under a tariff-quota regime, we offered three potential avenues, all of which have their own flaws. Economists would concur that auctions are the most efficient quota-allocation method. Yet we have to remark that exporter rents are dissipated in the bidding process and will end up going to the importing government – a situation that may be politically contentious. New forms of auctions should be assessed that allow inframarginal exporters to participate in the quota rents, so as to encourage their participation in the quota auction.

4.2 *Looking forward: the relationship between compliance Panels and Article 22.6 arbitrations*

An appeal of an Article 21.5 proceeding is the last hurdle faced by a successful complainant before an Article 22.6 arbitration can take place. By virtue of Article 22.7 DSU, the arbitrator is tasked with quantifying the amount of suspensions of concessions or other obligations to which the complainant is entitled.¹²⁴ Looking at the *Bananas III* appeal of the US and Ecuador's compliance challenge, we find it surprising that the AB did not seize the opportunity to indicate more clearly how its findings will affect and color an arbitrator's calculation of countermeasures under Article 22.4 DSU.¹²⁵

Surely, the AB Members understand the salience of Article 22.6 arbitrations. Even if they do not take place with high frequency, the type and amount of trade sanctions awarded to the complainant may well have a significant impact on how frequently the dispute-settlement system is used in the first place, and even on the size of *ex ante* trade-liberalization commitments by WTO Members.¹²⁶

123 Governments should be careful with how the auction revenues are being used. Handing them over to domestic import-competing firms à la *US–Byrd* and *US–FSC* is potentially WTO inconsistent.

124 Article 22.7 DSU reads in pertinent parts: 'The arbitrator acting pursuant to paragraph 6 ... shall determine whether the level of such suspension is equivalent to the level of nullification or impairment. The arbitrator may also determine if the proposed suspension of concessions or other obligations is allowed under the covered agreement.'

125 Article 22.4 DSU reads: 'The level of the suspension of concessions or other obligations authorized by the DSB shall be equivalent to the level of the nullification or impairment.'

126 If WTO dispute settlement systematically *under*-compensated successful complainants, Members anticipating ever to be in that situation will react in several ways, all of which seriously impair the

We note three issue areas in which the AB could have shed more light on how its rulings in the Article 21.5 appeal affect the subsequent Article 22.6 proceedings, but decided not to do so. These issues are: (i) the implication of ‘overlap and coincidence’ of nullification or impairment (NoI); (ii) the starting date of retaliation and how to deal with repealed measures; (iii) how different definitions of NoI influence the calculation methodology.

4.2.1 *The implication of ‘overlap and coincidence’ of NoI*

In connection with its Article XIII appeal, the EC claimed that the compliance Panel had failed to explain how the EC’s violation of Article XIII ‘caused any *new* or *additional* nullification or impairment to Ecuador ... beyond the nullification under Article I’,¹²⁷ which the EC had conceded to by not appealing it. According to the EC, the Panel had ‘double-counted’ the trade damage accruing to Ecuador.¹²⁸ The AB responded that nullification or impairment (NoI) resulting from inconsistencies with Article I:1 and XIII may ‘coincide or overlap, and that any such overlap is relevant only to the calculation of the total level of nullification or impairment’. It concluded that it does ‘not need to pronounce on such questions in these Article 21.5 proceedings’.¹²⁹

In the case of NoI experienced by the US, the EC held that the arbitrators in the original Article 22.6 proceedings in 1999 had found that the *sources* of NoI of benefits accruing to the US had uniquely been claims under the GATS and that no GATS obligations were at issue in the present 21.5 dispute.¹³⁰ The AB replied that it had not held in the original proceeding that the United States had suffered NoI exclusively as a result of violations of the GATS and that the GATS was not the only source of trade damage.¹³¹ Hence, it established an overlap of NoI under different agreements. The AB concluded:

We agree with the arbitrators that the question whether nullification or impairment exists within the meaning of Article 3.8 of the DSU, and the question of what level of suspension of concessions is equivalent to the level of nullification or impairment under Article 22.6, are distinct. [footnote omitted] *Therefore, the*

functioning of the multilateral trading system. Members may decide to refrain from litigating and instead resort to *extra*-contractual means of retribution and/or aggressive self-help behavior. They may opt for bilateral resolution outside the WTO forum, seek retaliation outside the trade realm (e.g. by political coercion), engage in unilateral retaliation (e.g. Section 301 of the *US Trade Act of 1974*), enact retaliatory AD action, enter into retaliatory litigation, or design strategic retaliation tactics (e.g. ‘carousel’ retaliation). In anticipation of a low retaliation amount, disgruntled Members may also decide to partially exit the WTO system by engaging in preferential trading agreements, by withdrawing from plurilateral agreements and protocols, or by refraining from participating in trade talks. Finally, disappointed Members may decide to liberalize less in future trade rounds (or to block a successful conclusion), in the hope of suffering less nullification or impairment in future disputes (Schropp, 2009a).

127 AB Report, para. 77 (emphasis in original).

128 AB Report, para. 358.

129 AB Report, para. 360.

130 AB Report, paras. 82, 474.

131 AB Report, paras. 473–474.

*question how the arbitrators calculated the level of nullification or impairment under Article 22.6 arises in a different procedural context in WTO dispute settlement.*¹³²

We submit that we would have liked to see more guidance from the AB in the issue of sources, overlap and coincidence of NoI. True, the task of quantification of trade damages is conducted uniquely by the arbitrator and not by the dispute Panel or AB,¹³³ but is it also the arbitrator's task to decide on the *sources* of NoI, and whether overlap and coincidence of NoI has occurred – and what the concept of 'overlap and coincidence' of NoI means in the first place?

First, it seems cursory by the AB simply to state that questions of the *sources* and *level* of NoI are 'different', that is distinct from questions of *existence* of NoI, and that it is only concerned with the latter, leaving the former questions in the hands of the arbitrator. This is not helpful, given that the reason why damage exists should bear some connection to how large it is. Hence, there is considerable overlap between the concept of *existence* and *sources*. We will deal with this relationship in subsection 4.2.3.

Next, on the issue of coincidence and overlap, the AB pronounced that overlap and coincidence of NoI exists, but shied away from discussing the implications of that finding. What is the arbitrator to do, if the same measure causes NoI under, say, Article XI GATT, and adverse effects in the form of serious prejudice under Article 5(c) of the *SCM Agreement*? Should he calculate one or two damage numbers? Should he then use the higher number? Or should he add both calculations and then determine and factor out areas of overlap? Generally, what *is* the overlap of serious prejudice and NoI? In addition, how can NoI caused by breach of two distinct GATT rules overlap? Are Members harmed more – or differently – under a violation of, say, Article III.2 than under Article XI GATT? The authors of this comment fail to see any systemic reasons why this would be the case. Yet, after the AB's pronouncement in *Bananas III*, arbitrators will have to start thinking about issues of overlap and coincidence, not least, since complainants may try to boost the numbers by claiming overlap instead of coincidence, whenever possible. In so doing, the arbitrator will have numerous question marks but no clarification from the AB.

4.2.2 *Expired measures and the starting date for retaliation*

With respect to the EC's repeal of the ACP tariff preference, the AB ruled that it 'consider[s] it to be within the discretion of the panel to decide how it takes into account subsequent modifications or a repeal of the measure at issue'.¹³⁴ The AB also referred to a remark made in its report in *US–Upland Cotton*, stating that

¹³² AB Report, para. 475 (emphasis added).

¹³³ In that respect, the EC is wrong in reproaching the AB with 'double-counting'. The AB does not 'count' NoI at all.

¹³⁴ AB Report, para. 270.

‘whether or not a measure is still in force is not dispositive of whether that measure is currently affecting the operation of any covered agreement’.¹³⁵

These statements hardly give any guidance to the arbitrator, who is supposed to deal with the quantification of NoI caused by a measure that is no longer in existence. Who decides whether a repealed measure should be included in the calculation of NoI, the dispute Panel/AB, or the arbitrator? If a Panel or the AB decides to take into account the repeal of the measure, that is rules against the existence of NoI, yet the arbitrator finds that the repealed measure has persistent effects, may the arbitrator calculate trade damages of the withdrawn measure nevertheless?

If a repealed measure is to be included, what is the cut-off date for such inclusion? In the present case, the repeal happened long after the original reasonable period of time (RPT), but before the end of the Article 21.5 proceedings. May the complainant ask for retaliation rights amounting to the damage suffered until the measure was repealed (or its effects subsided)? A similar issue came up in the Article 22.6 proceedings in the *US–Upland Cotton* case,¹³⁶ when the US repealed a prohibited cotton export subsidy (the so-called Step 2 payments) one full calendar year after the end of the RPT.¹³⁷ Brazil as the complainant demanded retaliation rights for a one-time countermeasure, while the US argued that the program was terminated and that Brazil was hence seeking authorization for *retroactive* remedies not permitted by the DSU. The United States essentially argued that countermeasures may only be authorized as long as a Member has not come into compliance with the DSB’s rulings and recommendations. According to the US, if there is no longer a measure, there is no more WTO inconsistency to be dealt with. Brazil opposed this view, arguing that retaliation rights begin with the end of the original RPT, and that Article 21.5 proceedings are a mere ‘suspension in time’. Thus, Brazil claimed, Article 21.5 proceedings are irrelevant for the sake of quantification of countermeasures (provided that the complainant wins the compliance proceedings).¹³⁸ Hence, according to Brazil, a one-time retaliation award compensating for the year after the RPT but before the repeal of Step 2 payments does not constitute retroactive damages, but is faithful to Article 4.9 of the *SCM Agreement*, which obliges the DSB to ‘grant authorization to the complaining Member to take appropriate [and not disproportionate] countermeasures’.¹³⁹

135 AB Report, para. 267.

136 *United States – Subsidies on Upland Cotton* (WT/DS267).

137 See the contribution of Bill Davey and André Sapir in this volume.

138 Brazil cited to the arbitrator in *US–FSC* and *US–Gambling* who held that countermeasures should be assessed as of the date of expiry of the implementation period.

139 For details of the *US–Upland Cotton* Article 22.6 arbitration, see <http://www.ustr.gov/trade-topics/enforcement/dispute-settlement-proceedings/wto-dispute-settlement/subsidies-upland-cott> (US submissions) and <http://www.mre.gov.br> (last visited 19 November 2009) (Brazil’s submissions).

Pending circulation of the arbitrator’s report in *US–Upland Cotton*, this issue is currently unresolved. It could, however, have been resolved by the AB long before at the opportunity of these *Bananas* proceedings, if the AB had been more explicit about how to deal with expired measures, and, more generally, whether counter-measures are measured starting from the original RPT or only after the Article 21.5 proceedings.¹⁴⁰

4.2.3 *The nature of nullification or impairment*

In its report, the AB made a series of statements about how to determine the existence of nullification or impairment. At various instances, the AB held that in order to assess whether the complainants had suffered any NoI, not only actual trade effects suffered were important. According to the AB, also “‘competitive opportunities’” and, in particular, any potential trade interest’ by the complainant matter.¹⁴¹ The AB also referred to a statement it had made in the original proceedings, opining that if the United States did not even have a potential export interest, ‘[t]he internal market of the United States for bananas could be affected by the EC bananas regime by its effects on world supplies and world prices for bananas’.¹⁴²

The AB’s three-pronged definition of NoI (actual trade damages; competitive opportunities; internal market of the complainant) should be given meaning in the subsequent arbitration process, even though its statements were made in the context of establishing the *existence* of NoI, and not the *level* of NoI, and even though compliance proceedings are procedurally different from Article 22.6 arbitrations.¹⁴³ *Existence* of NoI predisposes its level.¹⁴⁴ In other words, we believe that in *Bananas III* the AB has defined the *nature* of NoI, and proclamation on the nature should logically be the basis for any calculation or quantification exercise.

If our interpretation is correct, according to which the AB’s definition of the nature of NoI cannot be logically detached from its quantification, then arbitrators will face new challenges in the quantification of NoI. The integration of *potential trade interests* and *competitive opportunities*, as well as damage suffered in the *internal market* of the complainant, is quite a departure from

140 We note here that if the United States’s interpretation were right and NoI were calculated as of the end of the 21.5 proceedings only, this would clearly impact on the substance, or even put an end to, future sequencing agreements between Members, because it would put complainants at a serious disadvantage.

141 AB Report, para. 469, citing the *US–Superfund* case. See also para. 466. By ‘competitive opportunities’, the AB apparently meant the United States’s opportunities to export bananas into the EC, but also its ‘competitive relationship’ with any banana exporting country in the world (see *ibid.* paras. 80, 81).

142 AB Report, para. 466. See also paras. 128, 175, 458, 470, 476.

143 AB Report, para. 475.

144 If the issues of *level* and *existence* of NoI were decoupled, that is if the level of NoI bore no relationship with trade damages suffered by the complainants, then the level could potentially be zero. But at a level of zero, NoI would not exist.

the way NoI has been interpreted (and calculated) so far, namely as actual trade damages, or ‘exports foregone’ suffered after the RPT (see Bown and Ruta, 2009; Schropp, 2009b). If we are right in believing that the definition of NoI must determine, or at least have an impact on, the methodology used for calculating the level of NoI, new ways of quantifying trade damages may become necessary.¹⁴⁵

To be clear, the authors believe that the question of *existence* of NoI is different from that of the *level* – but not independent of it. It is the responsibility of Panels and the AB to determine whether NoI exists and the separate responsibility of Article 22.6 arbitrators to then quantify it. Nevertheless, to guide arbitrators in their already difficult job, WTO Panels or the AB should be more precise about what they believe the nature of NoI to be, and in what ways this could affect or determine the damage calculation. This, we believe, will greatly support arbitrators in their work.

To summarize, although there is no doubt that the framers of the DSU entrusted the 22.6 arbitrator with the ultimate calculation of the amount of NoI, the authors believe that it is the Panel’s or the AB’s obligation to make clear the nature and duration of the NoI it finds, so that arbitrators need not wonder which elements they should evaluate. In the present *Bananas III* (21.5) report by the AB, just as in many other reports, the AB has left too many issues for the arbitrator to deal with. In particular, the AB was slightly remiss in giving too little indication and guidance as to how the arbitrator shall deal with the issues of (i) overlap and coincidence of NoI, (ii) previously repealed measures, and (iii) the relevant definition of NoI.

Some authors have rightly argued that Article 22.6 arbitrations could benefit from Appellate Body review (e.g. Lockhart, 2009), and arbitrators on occasion have lamented over the lack of guidance that the DSU holds in stock for the calculation of NoI. This should encourage the AB to spend more time and thought on the consequences that their statements (or the omission thereof) will have on this last step of WTO litigations.

¹⁴⁵ If NoI is defined as *impairment of competitive opportunities*, a quantification methodology based on discounted cash flows, or option-pricing models is pertinent. If NoI is defined as damage suffered in the *internal* market of the complaining party as a result of the respondent’s measure in question, another calculation methodology may be needed: to quantify damages based on factors *intrinsic* to the complaining country’s domestic markets, a calculation akin to those required by Article 6.3 of the *SCM Agreement* may be applied. To recall, Article 6.3 of the *SCM Agreement* defines trade damage (serious prejudice) inter alia as price undercutting in the market of another Member, significant price suppression and depression, lost sales, or increase in the world market share of the subsidizing Member. The calculatory benchmark for these damages is quite different from the ‘exports foregone’ standard so far applied in Article 22.4 DSU cases.

5. Conclusion

At first glance, the Appellate Body Report in *Bananas III (Article 21.5; Second Recourse)* does not seem to be a case for the *Guinness Book*. The EC should not have appealed the Panel Report, and the AB did a good job upholding most of the Panel’s findings. It is at second sight that the AB Report reveals its interesting facets. Practitioners may be interested in the role of *estoppel* in WTO litigation, the legal effect of Panel suggestions, the relevance of modalities papers as interpretative tools, and other legal aspects we discussed. Readers more interested in law and economics theory may find food for thought in our examination of the economics of tariff quotas and the inherently discriminatory nature of Article XIII:2, our assessment of temporary opt-outs in the WTO, or our discussion of the relevance of compliance proceedings for the damage calculation under Article 22.6 of the DSU.

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Appendix I: Order of events in Banana III

Date	Measure/event	Annotations
1993/02/13	EC Regulation 404/93 enters into force ‘Original Banana Import Regime’ (the ‘Common Market Organization for Bananas’)	Measure at issue in original <i>Bananas III</i> litigation – Deficiency payment system for EU banana importers – Special distribution of import licenses depending on the origin of traders – Preferential tariff quota of 857,700 mt for ACP countries at zero tariff – MFN tariff quota of 2 million mt – Prohibitive out-of-quota tariff rate of €680/mt
1994/10/01	EC Tariff Schedule on bananas, incl. Bananas Framework Agreement (Annex to EC’s GATT Schedule)	Annex indicates ‘terms, conditions or qualifications’ of tariff schedule – Introduction of a global basic tariff quota fixed at 2,200,000 mt for 1995, subject to enlargement of the European Union – Introduction of country-specific allocations of quota rights to Venezuela, Costa Rica, Colombia, and Nicaragua taken from the global MFN quota – In-quota tariff of 75 €/mt – Para. 9 states that the Agreement shall apply until 31 Dec. 2002
1997/09/25	DSB adopts Panel and AB reports in original <i>EC–Bananas III</i> case	– Original Banana Import Regime not justified by Banana Framework Agreement, Agreement on Agriculture, Lomé Article I Waiver – Violation of Arts XIII, I:1, and III:4 GATT and Arts. II and XVII GATS
1998/12/18	Request for first 21.5 Panel by Ecuador	
1999/01/01	EC Regulation 2362/98 in combination with Council Regulation 1637/98 (adopted 1998/10/28, effective 1999/01/01) ‘Compliance Banana Import Regime’	Unsuccessful attempt to comply with original DSB rulings and recommendations (R&R) EC Regulation 2362/98 replaces earlier regime in response to R&R in original <i>EC–Bananas III</i> Report: – Duty-free TRQ of 857,000 mt for ACP – TRQ of 2,553,000 mt with tariff of 75€/mt for MFN suppliers – Out-of-quota imports: ACP are granted €200 preference

Appendix I (Cont.)

Date	Measure/event	Annotations
1999/04/09	Decision by 22.6 Arbitrator in US case	Arbitrator awards level of suspension of concessions and other obligations up to an amount of US\$191.4 m/year (United States) and US\$201.6 m/year (Ecuador). The US suspends tariff concessions; Ecuador does not exercise its rights to suspend concessions under GATT, GATS, and TRIPS
1999/05/06	DSB adopts first 21.5 Report (not appealed)	Measures taken by EC (under Regulation 2362/98) inconsistent with Arts. I and XIII GATT – Panel made suggestions pursuant to Art. 19.1 DSU how EC could bring its measures into conformity
2000/03/24	Decision by 22.6 Arbitrator in Ecuador case	
2001/01/29	EC Regulations 216/2001 and 2587/2001: Amended EC Reg 404/93 'Interim Banana Import Regime'	EC Banana Regime 2002–2005 was never challenged – TRQ A of 2,200,000 mt for all suppliers at 75€/mt for MFN suppliers and zero tariff for ACP – TRQ B of 453,000 mt for MFN suppliers at 75€/mt for MFN suppliers and zero tariff for ACP – TRQ C of 750,000 mt at zero tariff for ACP – Out-of-quota tariff: tariff preference of €300 for ACP countries
2001/04/11	Understanding on Bananas with US	(see p. 81 of AB report) – EC promises to introduce a tariff-only regime for banana imports no later than Jan. 1, 2006 – in the interim EC will implement an import regime on the basis of historical licensing effective as of July 1, 2001 – EC considers Understanding a mutually agreed solution – Ecuador and US consider Understanding a means by which dispute can be solved
2001/04/30	Understanding on Bananas with Ecuador	See p. 5 of AB Report
2001/11/14	Doha Article I Waiver including Annex on Bananas	– Waiver grants preferential tariff treatment for ACP countries – Annex sets out special two-stage arbitration process for re-binding on EC tariff schedule – Subject to fulfillment of rebinding requirements, Waiver applies until 31 Dec. 2007

Appendix I (*Cont.*)

Date	Measure/event	Annotations
2001/11/14	Doha Article XIII Waiver	Waiver grants TRA of 775,000 mt at zero tariff to ACP countries
2005/01/01	EU enlargement from ‘EU 15’ to ‘EU 25’	Enlargement of customs union forces EC to rebind its banana tariff in accordance with Art. XXVIII GATT
2005/01/31	EC informs WTO of intension of rebinding bananas tariff schedule under Art. XXVIII	2-stage Arbitration process according to Doha Article I Waiver is kicked off
2005/08/01	1st Rebinding Arbitration report against EC following ‘Modified Offer (I) on Banana Import Regime’	EC’s offer of an MFN tariff of 230€/mt is rejected
2005/10/27	2nd Rebinding arbitration report against EC following ‘Modified Offer (II) on Banana Import Regime’	EC’s offer of a tariff of €187/mt and 775,000 mt duty-free TRQ for ACP is rejected
2006/01/01	EC Regulation 1964/2005 (adopted 2005/11/29) enters into force ‘Bananas Import Regime’	Measure at issue: – Single tariff rate of €176/mt for all MFN suppliers – TRQ of 775,000 mt for ACP countries with zero tariff
2006/01/01	Deadline for EC introduction of tariff-only regime according to Understanding on Bananas	EC did not enact a tariff-only regime; instead, it introduced Regulation 1964/2005
2007/03/20	Establishment of Ecuador 21.5 Panel	
2007/07/12	Establishment of US 21.5 Panel	
2007/12/20	EC Regulation 1528/2007 ‘Novel Banana Import Regime’	– Repeals EC Regulation 404/93 – Modifies Regulation 1964/2005 – Eliminates preferential TRQ for ACP – Establishes a tariff-only import regime for bananas
2008/04/07	Circulation of Ecuador 21.5 Report	
2008/05/19	Circulation of US 21.5 Report	
2008/08/28	EC informs WTO of Appeal	
2008/08/29	Adoption of US and Ecuador 21.5 report	
2008/11/26	AB Report on <i>Bananas III</i> (21.5) is issued	