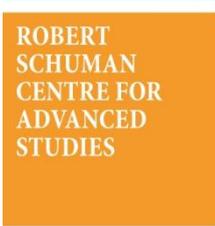




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**Bite the Bullet:**

Trade Retaliation, EU Jurisprudence and the Law and  
Economics of ‘Taking One for the Team’

Bernard M. Hoekman and Petros C. Mavroidis



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## **Abstract**

This paper discusses the Fedon case law of the European Court of Justice (ECJ), which involved a claim for compensation by Fedon (an Italian producer of eye glass cases) from the EU for the imposition of WTO-authorized retaliatory trade barriers by the United States following the failure by the EU to comply with an adverse ruling by the WTO regarding its import-regime for bananas. As a result of the EU non-compliance, European banana distributors and some bananas producers benefitted from WTO-illegal protection, at the expense of a set of EU exporters, including Fedon, that were hit by US countermeasures. By not complying with its international (WTO) obligations, the EU redistributed income across producers in different sectors as well as between suppliers and consumers of bananas. Fedon contested the non-compliance by the EU before the ECJ and sought compensation. This paper assesses the ECJ ruling against Fedon and argues that the ECJ got it wrong, both in terms of legal principle and as a matter of legal technicalities. An alternative approach is proposed that would better balance individual rights to property against the 'general' EU interest whether or not to comply with adverse WTO rulings.

## **Keywords**

Trade agreements, retaliation, dispute settlement, compensation, EU law, WTO

**JEL Classification:** F13, K41, K42



## 1. Introduction\*

In 1998, as part of a long-running dispute between the US (as well as several banana producers in Latin America) and the EU, the Appellate Body (AB) of the WTO found that the EU policy regime for imports of bananas was inconsistent with various provisions of the WTO dealing with trade and goods and services (*EC–Bananas III*). After elapse of the reasonable period of time for implementing the AB ruling, the US requested authorization to retaliate against products originating in the EU given that the EU had failed to comply.<sup>1</sup> Countermeasures in the WTO to date have taken only one form: suspension of concessions in WTO-legalise, whereby the injured state imposes a cost equivalent to that created by the WTO-violating measure(s) put in place by the author of the illegal act. Usually this is done by increasing tariffs on imports of products originating in the trade partner, although concessions in other areas (trade in services, trade in intellectual property rights) as well can conceivably be withdrawn.

In the absence of agreement between the EU and the US on the appropriate level of countermeasures, this matter was submitted to arbitrators.<sup>2</sup> Based on a decision by the arbitrators, the WTO (through the DSB, the Dispute Settlement Body) authorized the US to impose annual retaliation in the amount of US\$191.4 million against products originating in the EU. The list of products on which tariffs were raised by the US included products made by Fedon, an Italian company manufacturing articles of a kind normally carried in the pocket or in the handbag, with outer surface of sheeting of plastic, of reinforced or laminated plastics (i.e., cases for eyewear). In April 1999 the US imposed duties of 100% ad valorem on imports of Fedon products,<sup>3</sup> leading to an extra duty of 95.4% on Fedon products (§34 of the CFI decision). Fedon suffered considerable damage as a result of the US measures,<sup>4</sup> and, through its request to the CFI<sup>5</sup> (and the European Court of Justice, ECJ, on appeal later), sought to be reimbursed for the damage suffered.<sup>6</sup>

The rest of the paper is organized as follows. In Section 2 we present and analyse the judgment, and explain why, in our view, the Court got it wrong. In Section 3 we briefly recap the consequences of the judgment, and discuss how similar decisions may affect the incentives of EU firms to invest in export markets. In Section 4 we explore whether Fedon could have been brought to the European Court of Human Rights (ECHR), and conclude that in light of the strategy followed such recourse was probably not in the cards. Finally, in Section 5, we present a proposal to establish a fund that would compensate innocent bystanders that are injured as a result of EU decisions not to abide by its international trade obligations. Our main conclusions follow in Section 6.

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<sup>1</sup> See Hoekman and Kostecki (2009) for a summary of the long saga of the bananas dispute in the WTO. The retaliation that is the focus of this paper was linked to the third time a formal dispute had been brought to the GATT/WTO. Guth (2012) recounts the end of the bananas saga and the eventual resolution of the dispute between the EU and the complainants.

<sup>2</sup> As per Art. 22.6 of the WTO Dispute Settlement Understanding (DSU).

<sup>3</sup> See T-135/01, on Fedon vs. Council and Commission of 14 December 2005.

<sup>4</sup> §46 of the CFI Fedon decision.

<sup>5</sup> The CFI was subsequently re-named the General Court. Mavroidis (2007) discusses the Court of First Instance (CFI) decision on Fedon

<sup>6</sup> The damage to Fedon was €2,289,242 including interest (§56, CFI Fedon decision).

## 2. Analysis of the Judgment

### 2.1 The Claims

The plaintiff raised two claims before the CFI:

- (a) even assuming that the EU authorities had not acted illegally, Fedon should still be compensated for the damage suffered since, under EU law, the EU organs can be held responsible if damage results from their legal actions;
- (b) that the EU had acted illegally (by practising a WTO-inconsistent bananas import regime) which provoked the US countermeasures and, as a result, Fedon suffered trade damage.

Both the CFI and the ECJ rejected both claims, albeit on different grounds.

### 2.2 Responsibility from Legal Actions

The CFI first noted that, for the EU to be held responsible, the damage must be unusual and special. In the case at hand, the CFI held that the damage suffered by Fedon was not unusual; hence its claim should be rejected. The CFI first explained (§153) that, as constant case law had made clear, the EU could be held responsible for legal actions if three conditions were cumulatively satisfied:<sup>7</sup>

- (a) a damage exists;
- (b) a causal link between the damage and actions by the EC institutions has been demonstrated; and
- (c) the damage is unusual and special.

The discussion in Fedon hinges on the interpretation of the term ‘unusual’, since the CFI satisfied itself that a damage indeed existed (§162), and that there was a causal link between the damage and the EU bananas import regime (§183). The CFI found that the damage suffered by Fedon was not unusual and for this reason rejected the claim of the plaintiff. Because of this finding, it did not proceed to establish whether the damage was special (§200).

Damage is unusual, in the CFI’s evaluation, if foreseeing it lies beyond the bounds of the economic risks that are inherent in the sector concerned (§191). In this case, the damage was deemed not unusual because Fedon could have foreseen that it could be exposed to the risk of confronting retaliation if it exported its products to the US market (§198). Why is this case? Simply because, so the CFI argued, there is an inherent vicissitude in the WTO system, which allows for countries to take counter-measures when they are facing illegality under the WTO (§§194–197). Since counter-measures could hit anyone, they could hit Fedon as well, so the argument of the CFI goes. Consequently, Fedon, in the CFI’s view, when deciding to export its product to the US market, should have taken into account that:

- (a) the EU would adopt the bananas regime it ended up putting in place;
- (b) that this would damage US interests;
- (c) that the US would decide to challenge the EU regime before the GATT;
- (d) that the GATT would find against the EU;
- (e) that the EU would not comply but modify its regime instead;
- (f) that the US would challenge the EU regime again, before the WTO this time;
- (g) that the new EU regime would have been found WTO-inconsistent;
- (h) that the EU would once again decide not to comply;
- (i) that the US would take counter-measures pending compliance;
- (j) and that the US counter-measures would hit Fedon products.

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<sup>7</sup> Dorsch Consult v. Council and Commission, ECJ, C-237/98, Rec. 2000, I-4549, §19.

Fedon should also have factored in that bananas distributors are a more powerful lobby in the EU than the industries and producers that would be selected for counter-measures by the US, since, otherwise, the EU would have decided to comply. Hence, Fedon should have anticipated not only that it would be hit by the US countermeasures; it should have also anticipated the identity of all other EU producers that would have been hit. Clearly it is ludicrous to expect any entrepreneur to foresee all the contingencies mentioned above. Even assuming that they can and do, what is the remedy? Stop exporting? But this would go against the very purpose of the WTO: to liberalize international exchange, which presumably is why the EU participates in it.

Even if one uses a much lower threshold for what can be expected of EU firms when planning export investments – such as the incorporation of a probability that the EU might violate its commitments and thus that EU exports might be retaliated against and that this might affect the firm in the future – it is unreasonable to expect this to be factored into any investment decision. In practice retaliation is very rare – in the 1990s (before the Bananas retaliation) less than 0.0002 percent of US imports had been subjected to retaliatory counter-measures directed at the EU.<sup>8</sup> The EU has a strong reputation among international business as a law-abiding trading power that consistently has called for a stronger rules-based multilateral trade regime and that has a long track record of abiding by its international trade commitments. Including a non-zero probability of the EU not abiding by its WTO commitments cannot reasonably be expected to have entered into any investment decision-making process.

In the event, this finding by the CFI was overturned. The ECJ, hearing this case on appeal, held that EU law, at its current stage of maturity, could not accommodate this type of claim. It did so against the elaborate opinion of the Advocate General who had taken position in favour of acknowledging EU responsibility stemming from a legal act (§§135, 169-172, and especially §188):

The Court has held that Community law as it currently stands does not provide for a regime enabling the liability of the Community for its legislative conduct to found an action in a situation where any failure of such conduct to comply with the WTO agreements cannot be relied upon before the Community courts. The claims for compensation by the applicants sought in particular to put in issue the liability of the Community for such conduct. Accordingly, the Court of First Instance could only dismiss those claims, whatever the arguments put forward by the applicants to support them.

Had the Court stopped here, one might have had little to add to the analysis. The soundness of the arguments presented by the Advocate General notwithstanding, it is at the end of the day the privilege of the ECJ to decide on the ambit of EU law: it is the final authority on how to interpret the policy space that has been ceded to the EU by the Member States. The Court however, attempted to justify its position by offering a quasi-moral explanation why it had to be this way. In §183 of the judgment it held:

With regard, more specifically, to the right to property and the freedom to pursue a trade or profession, the Court has long recognised that they are general principles of Community law, while pointing out however that they do not constitute absolute prerogatives, but must be viewed in relation to their social function. It has thus held that, while the exercise of the right to property and to pursue a trade or profession freely may be restricted, particularly in the context of a common organisation of the market, that is on condition that those restrictions in fact correspond to objectives of general interest pursued by the Community and that they do not constitute, with regard to the aim pursued, a disproportionate and intolerable interference which infringes upon the very substance of the rights guaranteed

This paragraph is difficult to understand. How can it be that general interest of the EU is to protect bananas distributors whose practices are violating the EU's commitments under the WTO (thus

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<sup>8</sup> US retaliation in the Hormones case was some \$120 million per year, compared to total US imports that averaged \$750 billion during the 1990s.

opening the way for the US to retaliate), while punishing Fedon and other firms that played by the rules all along? This raises the question as to what the benchmark is for evaluating the general EU interest. Should Fedon understand that the social function of its property rights is to subsidize the income of bananas distributors? The Court can of course hide behind the case law that the general EU interest is not justiciable. But is this practice consistent with the idea of the rule of law and the 'Rechtsstaat' that the EU supposedly is pursuing, especially since we are not dealing with a legislative action proscribing the irrelevance of WTO law, but with judge-made law only? We will revert to this matter in what follows.

### **2.3 Responsibility for Committing an Illegality**

The CFI had held that the EU institutions did not commit an illegality in violating its WTO commitments, and that, consequently, the EU had no obligation to compensate Fedon (§142). Three conditions (commission of an illegal act; damage; and a causal link between the two) must be cumulatively met for compensation to be due. One of these (commission of the illegal act) was missing in this case, as in the CFI's view WTO law is not a valid benchmark against which the legality of EU law will be measured (§103). The CFI argued that it would only be a valid benchmark if:

- (a) the EU intended to execute a particular obligation assumed at the WTO-level, or
- (b) EU legislation explicitly refers to WTO law (§107).

The CFI observed that neither of these limiting conditions was present in this case, and, therefore, it concluded that Fedon could not invoke WTO law to establish the EU's responsibility (§135). The ECJ upheld this finding of the CFI as well as its rationale. The key paragraphs in the ECJ decision are reproduced below.

111 As regards, more specifically, the WTO agreements, it is settled case-law that, given their nature and structure, those agreements are not in principle among the rules in the light of which the Court is to review the legality of measures adopted by the Community institutions (see, in particular, *Portugal v Council*, paragraph 47; *Biret International v Council*, paragraph 52; and *VanParys*, paragraph 39).

112 It is only where the Community has intended to implement a particular obligation assumed in the context of the WTO, or where the Community measure refers expressly to the precise provisions of the WTO agreements, that it is for the Court to review the legality of the Community measure in question in the light of the WTO rules (see *Biret International v Council*, paragraph 53, and *VanParys*, paragraph 40 and the case-law cited).

115 Court also held in that judgment that, by undertaking after the adoption of the DSB's decision of 25 September 1997 to comply with the WTO rules and, in particular, with Articles I(1) and XIII of the GATT 1994, the Community did not intend to assume a particular obligation in the context of the WTO, capable of justifying an exception to the principle that WTO rules cannot be relied upon before the Community courts and enabling the Community courts to review the legality of Regulation No 1637/98 and the regulations adopted to implement it in the light of those rules (see, to this effect, *Van Parys*, paragraphs 41 and 52).

116 It should be remembered that the decisive factor here is that the resolution of disputes concerning WTO law is based, in part, on negotiations between the contracting parties. Withdrawal of unlawful measures is admittedly the solution recommended by WTO law, but other solutions are also authorised (*Omega Air and Others*, paragraph 89).

119 The Court also pointed out that to accept that the Community courts have the direct responsibility for ensuring that Community law complies with the WTO rules would effectively deprive the Community's legislative or executive organs of the scope for manoeuvre enjoyed by their counterparts in the Community's trading partners. It is not in dispute that some of the contracting parties, including the Community's most important trading partners, have concluded from the subject-matter and purpose of the WTO agreements that they are not among the rules applicable by their courts when reviewing the legality of their rules of domestic law. Such lack of

reciprocity, if accepted, would risk introducing an imbalance in the application of the WTO rules (*Van Parys*, paragraph 53).

129 A recommendation or a ruling of the DSB finding that the substantive rules contained in the WTO agreements have not been complied with is, whatever the precise legal effect attaching to such a recommendation or ruling, no more capable than those rules of conferring upon individuals a right to rely thereon before the Community courts for the purpose of having the legality of the conduct of the Community institutions reviewed. (*italics in the original*).

In what follows we take each of these grounds for rejecting Fedon's claim in turn and question their validity.<sup>9</sup> We should state at the outset that the Court did not have to go into such great pains to reach its conclusion: it could for example have mentioned only the first of the grounds for rejecting Fedon's request, i.e., that the WTO law is not a benchmark on which to evaluate the legality of EU actions in the field of international trade policy except for the two instances mentioned above, neither of which was present in the instant dispute. Why spend time and effort mentioning the other grounds as well?

### 2.3.1 WTO Law is Benchmark in only Two Cases

No express reference to WTO law. The ECJ found nowhere in the relevant EU documents an explicit reference to WTO law, so the conclusion in the eyes of the judges was inescapable. But is not this construction tantamount to stating that the performance of international obligations will be decided on the basis of domestic law? Such an attitude is clearly in contradiction with customary international law rule enshrined in Art. 27 VCLT (Vienna Convention on the Law of Treaties):

A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.

The EU did not intend to abide by the DSB decision. The DSB (Dispute Settlement Body) decision reflects the adoption of the WTO Appellate Body (AB) report condemning the EU practices (the EC–Bananas III report). In the ECJ's view there is an inherent vicissitude in WTO law which distinguishes it from other legal systems: once inconsistency has been established, the author of the illegal act does not have to implement its obligations; it can negotiate some form of compensation. The EU did not intend to assume a particular obligation when the DSB decision fell; were the ECJ to grant Fedon compensation, it would have had ipso facto, so the argument goes, deprived the EU executive from negotiating a deal with its trading partners.

From a practical perspective, an ECJ decision in favour of the plaintiff does not have any effect on the EU's discretion to negotiate a deal with its trading partners: Fedon requests compensation for costs it has already incurred (the extra tariffs it has been forced to pay, and the lost sales that result from a 100% tariff). The EU could have compensated Fedon while looking for a negotiated settlement with the US. Because of the de facto absence of retroactivity of WTO remedies, there is no risk of paying twice. Actually, the EU is paying the US less, substantially less in this case, than the damage it has caused: the damage starts from the date the illegality occurred; the obligation to compensate kicks in, by WTO case law-construction, at the end of the reasonable period of time within which the EU should have complied with the adverse ruling.<sup>10</sup>

More importantly, it is very disturbing to hear from the ECJ that an international treaty will be the benchmark if, and only if, the EU intended this to be the case. The message to the EU's trading partners is that when the EU signs international treaties, sometimes it might, and sometimes it might not intend to abide by it. Our judges should think about the incentives they create for our (trading) partners through similar case law.

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<sup>9</sup> Alemanno (2008), Arcuri and Poli (2010), and Dani (2010) have all offered critical comment on the Fedon judgment.

<sup>10</sup> Mavroidis (2000) discusses the de facto absence of retroactivity of WTO remedies.

### 2.3.2 Flexibility of the WTO Contract

The ECJ, when arguing that the EU's options will be constrained if compensation were paid to Fedon, mischaracterizes the WTO by describing it as a totally flexible instrument when it comes to compliance. As a matter of principle, Art. 22 DSU<sup>11</sup> reveals a clear preference in favour of 'property rules' (specific performance of the contract); 'liability rules' (suspension of concessions) in the WTO is an interim solution that is only available until compliance has been achieved, and is aimed at inducing compliance. The obligation imposed on the EU by virtue of the DSB decision is to remove the illegal practice; in the meantime, until the moment when compliance has occurred, the EU could be paying compensation. In this respect, there is no difference between WTO and EU law: indeed the latter also, on occasion, provides for a payment of fines until compliance has been achieved. Neither legal order can prejudge when compliance will occur, and many factors (which we could encompass in the term 'opportunity cost of non-compliance') can affect whether and when compliance will occur. It follows that from a compliance perspective, being subjected to countermeasures is not a solution equivalent to specific performance of the obligations assumed. If the ECJ aims to suggest that all systems with interim liability rules are, because of this idiosyncratic element, systems which do not require specific performance, it will have to consider the implications of this statement for the EU legal order as well.

What about the payment of compensation which is also envisaged in Art. 22 DSU? Payment of compensation is also an interim solution until compliance has been achieved. Hence, being subjected to compensation does not amount to compliance. The function of compensation is thus identical to that of suspension of concessions, and the differences between the two instruments are that the former is a negotiated settlement between author of the illegal act and injured party, whereas retaliation could<sup>12</sup> be the outcome of arbitration; retaliation always takes the form of suspension of concessions or other obligations, while the form compensation can take is not statutorily prescribed. In practice, compensation has been paid only twice since the establishment of the WTO in 1995.<sup>13</sup>

### 2.3.3 Reciprocity Considerations

The ECJ pays attention to the fact that other WTO Members do not allow private parties to claim compensation before domestic courts for violations of the WTO contract. The Court however, fails to explain why this is a legally-relevant consideration. It could be a policy-relevant consideration, but making policy is not the mandate of the ECJ. The conditions under which private parties can invoke any law before the ECJ should be defined using as benchmark one body of law only: EU law. Standing should be conferred using domestic, not foreign, law as benchmark.

### 2.3.4 Absence of Direct Effect of WTO Law

The Fedon case is not about direct effect. Fedon did not argue that by virtue of a WTO provision it was entitled to a sum of money; Fedon argued that because of illegal actions by the EU (in principle, irrespective whether these were in breach of its international obligations or not), it suffered trade damage. The source of its claim is not WTO law, but EU actions. The legal point here is that using the WTO law as benchmark for testing the legality of EU actions is completely dissociated from direct effect. In fact the Court seems to conflate two distinct questions, namely:

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<sup>11</sup> DSU stands for Dispute Settlement Understanding, the WTO Agreement regulating dispute settlement.

<sup>12</sup> We say 'could', because it could also be the case that the two parties agree on the list of suspension of concessions as presented by the injured party. In this case, there is no need to have recourse to arbitration under Art. 22. DSU).

<sup>13</sup> Both times involving payment by the US: once in a dispute on cotton with Brazil and once in a dispute on copyright with the EU. The latter is analysed in Grossman and Mavroidis (2003). We return to these instances below.

- (a) is the WTO law, as interpreted by WTO courts, a legal benchmark to evaluate the consistency of EU actions/omissions with its international obligations?
- (b) who can invoke WTO law, as interpreted by WTO courts, before the ECJ?

The Court has on a number of occasions dealt with this question. In 'Racke' (C-162/96), the Court entertained the complaint by an individual against an EU regulation that had suspended the concessions granted under an international trade agreement to Yugoslavia. Racke, the individual, was arguing that the EU action was tantamount to a violation of the basic legal maxim *pacta sunt servanda*. In §51 of its judgment the Court held:

In those circumstances, an individual relying in legal proceedings on rights which he derives directly from an agreement with a non-member country may not be denied the possibility of challenging the validity of a regulation which, by suspending the trade concessions granted by that agreement, prevents him from relying on it, and of invoking, in order to challenge the validity of the suspending regulation, obligations deriving from rules of customary international law which govern the termination and suspension of treaty relations.

Years later, the same court, in C-366/10, was entertaining a claim by private operators (aviation companies) to the effect that the extension of the EU emissions trading scheme (limiting pollution by airplanes) to foreign carriers was not consistent with the EU obligations under customary international law. In §110 it held:

However, since a principle of customary international law does not have the same degree of precision as a provision of an international agreement, judicial review must necessarily be limited to the question whether, in adopting the act in question, the institutions of the European Union made manifest errors of assessment concerning the conditions for applying those principles (see, to this effect, *Racke*, paragraph 52).

In none of these cases did the international law invoked by the complainants confer rights to individuals, and yet the Court did not reject the claims submitted arguing absence of direct effect. What is then so special about WTO law? In fact, we think that *Fedon* was an opportunity for the Court to draw an analogy with the *Kraaijeveld*-jurisprudence<sup>14</sup> of the ECJ, where the Court moved away from direct effect-type of considerations to evaluate the legality of Dutch law. *Fedon* could have been the *Kraaijeveld*-equivalent for using international law to evaluate the legality of EU law. The ECJ failed to do that. This attitude however, can only incite similar reactions by others and ultimately may have detrimental impacts on international cooperation.

To avoid any misunderstandings, we are not advocating direct effect of WTO law here.<sup>15</sup> We are simply advocating that the WTO should be recognized as the benchmark to discuss the legality of EU actions. It is after all the EU that insisted on Art. 23.2 DSU which confers exclusive jurisdiction to WTO courts to interpret the covered agreements.<sup>16</sup> Now, a few years later, it is the same EU that denies the WTO courts' authority to do so. It seems that EU courts have adopted an attitude identical

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<sup>14</sup> Prechal (2002) at pp. 17 ff. There is extensive case law where the Court dissociated the question of direct effect from that of consistency of EU law with public international law. Somehow, WTO-related case law is the one area where this is not the case.

<sup>15</sup> A society has to weigh how it treats the right to property against its own incentives to comply with international obligations it has freely incurred. The whole idea of direct effect (i.e., that a private party can invoke before a court a provision of the EU treaty) underlying the landmark 1962 *Van Gend en Loos* decision was to ensure that private parties also derive rights from the EU construct and that this does not remain an isolated institution/document tucked away from reality. Direct effect should lead to more challenges, more testing of EU law by widening the basis of those who can invoke it (private parties as well, and not just states as was the case before *Van Gend en Loos*). Now the Court has turned this on its head: private parties cannot invoke it, while States cannot invoke WTO law.

<sup>16</sup> Stewart (1999) contains all proposals submitted during the negotiations of the Uruguay round concerning Art. 23.2 DSU which reflects the obligation to submit disputes regarding the operation of the various WTO Agreements exclusively to the procedures established under the DSU.

to that of US courts. In *Corus Staal BV and Corus Steel USA Inc. v. the Department of Commerce*, [395 F. 3<sup>rd</sup> 1334 (Fed. Cir 2005)], the CAFC (Court of Appeals for the Federal Circuit), effectively held that the ‘Charming Betsy’ doctrine [*Murray v. The Schooner Charming Betsy*, 6 US (2 Cranch) 64, 118 (1804)], according to which courts should interpret US law whenever possible in a manner consistent with international obligations, does not apply to WTO dispute settlement decisions which are not binding on the US. The implication is that reciprocity considerations seem to matter a lot.

No one is denying that private interests could be hurt as a result of pursuit of trade policies that are deemed to be in the general interest. Trade liberalization is, in general, welfare enhancing but this does not mean that there are no losers in national markets. Levy and Srinivasan (1996) show why it can make good sense to assign the responsibility to decide on questions such as the one at issue here (whether to comply) to the central government. Assigning the responsibility to a government guarantees that the society as a whole will profit from opening up the market (assuming the government acts to increase social welfare, a strong assumption, alas, on this occasion at least). It is up to the government then to decide whether to compensate losers. The questions for EU should be: is the exercise of our trade policy in the general interest? And if yes, what should the EU be doing to compensate those who end up losing in the name of general interest?

In the present case, the response to the first question by most economists (and consumers) is likely to be a resounding ‘no’. Of greater significance is the second question: whether to compensate. The answer of the Court (and other European institutions) is ‘no’ again. In our view, refusing to compensate those who through their own industry are able to penetrate foreign markets and are subsequently excluded for no fault of their own is not satisfactory. It is this dimension of the case at hand that provides a rationale for compensation. We are not making a general argument that all losers from EU trade policy should have a legitimate claim for compensation. This would not only be unworkable but inappropriate as well. Trade policy in any democratic polity is made through a process in which competing and conflicting interests lobby for the policies that are most advantageous to them. The outcome of this policy-formation process is endogenous but presumably reflects a “political economy equilibrium” that is deemed to be what “society wants”. In this process there will be winners and losers but the losers will have had a shot at influencing the outcome. This outcome includes the various commitments that the EU negotiates in the WTO. The situation in the case at hand is very different: the outcome that reflects the political economy equilibrium is altered as a result of an action by a trading partner to defend its negotiated WTO rights that responds to an EU decision not to abide by its commitments.

### **3. Bite the Bullet, Fedon (so says your Court)**

By keeping the WTO illegality in place the EU is essentially engaging in a redistributive policy: the bananas-importers (those selling ACP bananas) were not exposed to a greater level of international competition as they would have been if the WTO ruling was implemented, and thus benefited from higher profits. Fedon and other EU firms hit by the US-countermeasures saw the return on the successful investments they made in penetrating the US market greatly reduced: they must bite the bullet.

The Court is there to test the legality of the actions of the agents of the European peoples, the EU institutions. The Court has established through its case law an elaborate system to test the legality of the activity of these institutions. Illegality can occur because either domestic or international law is breached. The EU has signed an agreement whereby it has accepted that WTO adjudicating bodies have a monopoly in determining the legality of actions by all trading partners (Art. 23.2 DSU). This is a contractual promise made by the EU to the rest of the world. Now that the WTO adjudicating bodies have made such a determination, the ECJ turns around and says that a wrong in the eyes of the WTO is not a wrong in the eyes of the EU institutions, because the EU action (or rather non-action) is in the general interest.

#### **4. Another City, Another Court: Fedon in Strasbourg?**

Arguably, Fedon could have also litigated before the ECHR. To this effect, the lawyers of Fedon would have to persuade the Court that their case comes under its competence (according to protocols 1 and 2, the Court is competent to adjudicate disputes regarding interventions to private property). Had it submitted a similar complaint, one can only speculate as to the eventual outcome. There are several legal as well as policy factors that cast doubt to the feasibility of similar action.

First, Fedon would have to act against an EU institution before a court lying outside the EU institutional architecture and for this reason alone, it might think twice before doing so: it is one thing to clean dirty laundry in the house (Luxembourg), and quite different to do so abroad. But assuming any such diffidence had been overcome, Fedon would have to face a series of legal impediments that it would probably find it hard to overcome:

First, there is the issue of causality: unless Fedon could show a causal link, in the legal sense of the term, between the EU decision to not comply with its obligations under the WTO and the damage inflicted to it, then its claim would not have succeeded in Strasbourg either. Now the response to this question is far from obvious: logically, there is rational connection between the two, in the sense that had the EU complied with its obligations then no damage could have ever resulted for Fedon. Rational connection is a looser test than causality though. The Court could, for example, have taken the view that between the EU decision to not comply and the damage suffered by Fedon the causal 'chain' is interrupted since the discretion of the US government enters the picture. In other words, since the US could have chosen a different target, the damage suffered by Fedon is not the direct result of the EU decision to not comply, but of the exercise of discretion by the US government.

But even if the Strasbourg Court takes the view that a causal link is established in the present case, then the EU could always respond that its actions were dictated by the pursuance of the general EU interest and that they were proportional to the objective pursued. It would take a very courageous Court indeed to second-guess the EU in this respect, and we have no tangible reason to invest in this perspective. For this reason we believe that a similar claim in Strasbourg would not end up the way Fedon would have wished to.

Fedon could also face arguments regarding, for example, exhaustion of local remedies: Fedon had not argued interventions to its private property before EU courts, and the doctrine of exhaustion of local remedies espoused by the ECHR could present yet another obstacle for the lawyers of Fedon.

Finally, under its 'Bosphorus' case law (2005), the ECHR has accepted the principle of equivalent protection between the EU and the ECHR-legal order. In this vein, the Court in Strasbourg might find it hard to decide against the level of protection afforded to Fedon by the Luxembourg court, even though the principle mentioned here simply creates a rebuttable and not an irrebutable presumption. Under the circumstances one can only conclude that a challenge before the ECHR was unlikely to succeed.<sup>17</sup>

#### **5. A Way Out of the Current Mess**

In effect, what we have in the case at hand is an example of a 'regulatory taking'. Fedon is not able to contest it because the action is deemed to be in the interest of the EU as a whole, but clearly it has suffered a loss as a direct result of the EU decision not to comply with the WTO ruling. The fact that the US imposes the harm is irrelevant, except insofar as the motivation underlying the countermeasures is to induce the EU to comply. The US action is costly, both to itself (US consumers

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<sup>17</sup> This conclusion nevertheless, should be taken with a pinch of salt. We can only state in definitive manner in presence of case law to this effect. There is none. As a result, it is probably recommendable (assuming manageable opportunity cost) to pursue a similar avenue in the future, the low likelihood of succeeding notwithstanding.

of the imported products pay higher prices and/or are induced to switch to less desirable varieties) and to the affected EU producers, their workers and their communities. Indeed, the costs of retaliation may be increased by the fact that the US uses a so-called carousel approach—it changes the list of products to retaliate on periodically, in the process creating uncertainty regarding the conditions of market access that will prevail for a larger set of EU exporters than those subject to retaliation at any given point in time.<sup>18</sup>

Action by the EU to compensate Fedon (and by implication, all the other EU firms hit by the US retaliation) would alter the incidence of the costs of countermeasures. Instead of telling some firms to bite the bullet and ‘take one for the team’ it would appear much more logical – given the presumption that the EU decision is in the general interest – that the cost of the retaliation be spread across the EU population. Offering financial compensation for trade losses incurred by the targeted EU firms would achieve this, as the compensation would have to be paid for. If it comes from general taxpayer-funded sources the costs of the EU policy would be spread widely, as is appropriate given that the general interest is served by the EU’s trade policy. This could also improve allocative efficiency and reduce the real resource costs associated with carousel retaliation—while firms would still be hit by higher tariffs if they are targeted, they can decide to pass on the compensation to their importers to allow them to offset the effect of the tariff.

A legal issue which might arise were such a solution to be adopted is that the EU could be accused before the WTO of subsidizing its domestic producers. Recall that by virtue of Arts. 1 and 2 of the WTO Agreement on Subsidies and Countervailing Measures (SCM), a scheme is considered to be a subsidy if a financial contribution confers a benefit to specific recipients. Two types of instruments (export subsidies and local content incentives) are illegal under the WTO; all other instruments that qualify as subsidies can be counteracted: a WTO Member can either impose countervailing duties (CVDs) against exports of companies that have benefitted from subsidies, or can challenge their consistency before the WTO and request that they be adjusted (or even, withdrawn). The question that arises here is whether the EU risks being accused for subsidization in case it compensates innocent bystanders like Fedon who have been hurt by WTO legal countermeasures.<sup>19</sup>

The first criterion, namely, financial contribution, is of course satisfied in our scheme.<sup>20</sup> There is doubt however that a benefit is conferred: were a Panel to take the view that a narrow set of facts is properly before it, that is, the provision of a financial contribution to operators, then undoubtedly the second criterion is met as well. However, if a Panel were to take the view that it has the mandate to inquire into the rationale for procuring a benefit, then the opposite should be true since, at the end of the day, economic operators will not be receiving anything beyond what they would have received from the market (assuming the compensation is limited to lost trade). Unfortunately there is no case law suggesting that an inquiry into the rationale for subsidization is appropriate when deciding whether a benefit has been conferred. Indeed, this was the reason for including Art. 8 in the SCM Agreement, a provision that exonerated from liability three forms of subsidies aiming at providing (more or less) public goods. Art. 8 SCM lapsed in 2000, however, and to date no WTO Panel has ever pronounced on similar grounds: a benefit has been bestowed, according to standard case law, if an

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<sup>18</sup> The incentive effects of pursuing carousel retaliation are ambiguous. A greater number of EU firms will need to factor in the probability of being hit – which can be expected to increase the number of firms and industries that will push for the EU to bring its trade policy into compliance with its WTO obligations – but carousel retaliation also reduces the cost of retaliation for EU firms that are hit as this will at least be time bound. Whatever the net impact on compliance incentives and total welfare cost of retaliation/noncompliance, how retaliation is put into effect has no implications for the argument for compensation.

<sup>19</sup> We should note at the outset that if the response is affirmative then the US in our example would have even more of an incentive to choose those targets that will make more noise through their lobbying efforts in Brussels, since the only way to make them stop making noise would be for the EU to comply with its obligations.

<sup>20</sup> This is not compensation in the sense of Art. 22 DSU since the beneficiary is not a third state but EU economic operators.

individual receives from the government what he/she could not receive from the market with no additional inquiry into the rationale for subsidization full stop.

We are thus left with the last element: specificity. Case law<sup>21</sup> has consistently held that both de jure (e.g. by statutory language the list of beneficiaries is limited to a few operators) and de facto (e.g. in the absence of similar statutory language, the measure operates so as to limit the list of beneficiaries to a few operators) schemes are covered. Adopting a law that would provide for compensation of innocent bystanders would fall, if at all, under the latter category. But then it would be impossible to demonstrate that the EU would know ex ante the identity of the firms that eventually would be compensated (subsidized). There is an analogy to free (but non-compulsory) education: a state provides it without knowing who will make use of it, let alone intending for specific beneficiaries. The identity of beneficiaries will depend on the action not of the subsidizer but of a third entity, in our example, the US. For these reasons, we believe that the better arguments lie with the view that similar schemes should not be considered specific.

An even better solution to the problem of addressing the specific costs to targeted firms from noncompliance by the EU is one where EU exporters are not retaliated against in the first place. Firms would then not confront the costs associated with reallocating output etc. Economists and lawyers have long advocated greater use of direct compensation of the negatively affected trading partner in cases like the one at hand.<sup>22</sup> The EU could have simply transferred the value of the lost trade volume as determined by the WTO arbitrators to the US, i.e., some US\$200 million a year.

As noted above, there is precedent for financial compensation to be used in instances where a WTO Member is not in a position to comply with a WTO ruling. In US – Section 110(5) Copyright Act, a dispute brought by the EU in which the WTO ruled against the US, the US was not able to revise its legislation within the reasonable period of time established by the WTO. Arbitration determined that the loss incurred by the EU as a result of the illegal US action amounted to €1,219,900 per year. As part of the Wartime Supplemental Appropriations Act, signed into law on 16 April 2003, the US Congress approved a \$3.3 million appropriation – to cover three years of payments – which was subsequently paid to the European Grouping of Societies of Authors and Composers, at the request of the European Commission.<sup>23</sup> There is no legal or technical impediment to the European Commission undertaking a similar initiative in the case at hand.

A solution along these lines was also adopted in US-Upland Cotton. In this case, Brazil won its claim that the US government had been subsidizing the production of upland cotton, and the two governments concluded a 'Framework for a Mutually Agreed Solution to the Cotton Dispute in the WTO'. According to the agreed framework, the US government agreed to transfer funds to an entity designated by Brazil. The Brazilian government would in turn use this money for technical assistance and capacity building activities such as promotion of use of cotton, natural resources management and conservation, application of post-harvest technology etc.<sup>24</sup> All such activities of course, could be characterized as subsidies, but no one mounted a challenge against Brazil for disbursing funds in this way.

In these two examples, the legal question remains the same: are we in presence of a subsidy? The difference between these two instances where compensation was paid and the solution we advocate to

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<sup>21</sup> For an overview of the case law in this respect, see Rubini (2009); see also Mavroidis, Messerlin, and Wauters (2008).

<sup>22</sup> See for example, Hudec (2002) and Bronckers and van den Broek (2005). Limão and Saggi (2008) show that a system of monetary fines that is supported by the threat of tariff retaliation is more efficient than one based on retaliation alone.

<sup>23</sup> The funds were used for combating piracy on the Internet and supporting actions to strengthen copyright enforcement in Europe and the United States—see Hoekman and Kostecki (2009). The details of the arbitration award are discussed in Grossman and Mavroidis (2003).

<sup>24</sup> WTO Doc. WT/DS267/45 of August 31, 2010. See also US Department of State, International Agreements Other Than Treaties Transmitted in Accordance with the Provisions of 1 USC 112b as Amended.

the innocent bystander problem from a pure legal perspective is that it could be the US that might be accused of subsidization. This is not compelling. While it is probably too early to speak of acquiescence, one case of compensation is an accident, but two cases start taking us down the continuum towards the direction of 'practice'. It seems that WTO Members are willing to accept that payments of this sort should not enter the framework of the SCM Agreement, either because they do not consider them to confer a benefit or because they fail the specificity-requirement.

While a shift towards the use of financial compensation would help solve one problem it may give rise to another. From a systemic, WTO compliance-perspective, such a move could reduce compliance incentives, as the individual (per EU household) cost of compensating the affected European firms will be (very) small—just a few Euros a year. At the same time, the evidence suggests that while firms like Fedon incur high costs and as a result have big incentives to lobby for policy reform (and to litigate), it is not very effective in inducing compliance. The illegal Banana policy lasted for many years. Complaints by negatively affected firms such as Fedon do not appear to have played any role in the eventual reform of EU policy.

There is a broader point here. At present, retaliation by one WTO Member randomly (at least from the perspective of the targeted firms) imposes excess costs on the affected exporters in the WTO member maintaining illegal policies. But the same would happen if the latter was to renegotiate the terms of the WTO contract with the former. Thus, if the EU were to take the position that it is not in its interest to comply with a WTO ruling it can offer the US other trade concessions. This would give rise to the same sort of effects as selective US retaliation: some industries and firms would be negatively affected on a rather arbitrary basis and therefore result in "inequitable" outcomes. This suggests there is a case for a general rule to be proposed: either offer financial compensation during the period in which there is no compliance with a WTO ruling or compensate all the exporters targeted by retaliation, in both instances shifting the cost to taxpayers. This leaves it to the US to continue to make the case in the WTO for compliance. If it becomes clear that there is not going to be compliance, the EU has the choice of either continuing to pay compensation indefinitely or to engage in renegotiations with the US. The latter is the primary mechanism foreseen in the GATT/WTO to address matters of this type and there is a long history of successful renegotiation of tariff commitments. We would argue that such renegotiations should be pursued in a way that affects all import-competing industries in EU proportionately so as to maintain the initial structure of relative protection, as that presumably reflected the political economy equilibrium that prevailed at the time the EU engaged in the original exchange of market access concessions with the US (and other WTO members if this exchange took place in a multilateral round of trade negotiations).<sup>25</sup>

An implication of our suggestion is that policy is moved towards improving economic welfare by lowering trade barriers. This is also a key dimension of the approach proposed by Lawrence (2003), who calls on WTO members when negotiating market access liberalization to identify *ex ante* which tariffs/sectors would be targeted for additional liberalization in cases such as the one discussed in this paper. In practice governments have not shown any interest in pursuing that idea, but the *ex post* approach sketched out above would be a feasible path to move from retaliation and the associated welfare costs towards a system where the remedy involves trade liberalization. Moving towards greater neutrality in the incidence of the adjustment costs associated with noncompliance/renegotiation would both safeguard the implicit property rights of EU firms and do more to protect the general interest – if defined as the overall economic welfare of the European Union.

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<sup>25</sup> In practice a uniform tariff reduction strategy is unlikely to be feasible because there is another party at the table with export interests in specific industries. Thus, reductions may need to be limited to a subset of sectors. But the principle of 'spreading the pain' as equitably as possible across EU industries should continue to apply.

## **6. Concluding Remarks**

The ECJ, in its Fedon judgment, confused two issues: the issue of relevance of WTO law (as benchmark to evaluate the consistency of EU actions with the international obligations assumed by the EU by virtue of its adherence to the WTO), and the issue of *locus standi*, e.g. who can legitimately claim a breach of WTO obligations by the EU before the Luxembourg courts. In doing that, it condoned a practice of re-distribution of wealth across segments of the EU society in the name of the 'general' EU interest. This is wrong. While we believe that there is no place for direct effect of WTO law in the EU legal order, we have argued why the EU should compensate losers like Fedon who play the game by the rules. Taking one for the team is commendable when it is the team, and not another individual player that profits. We have pointed to avenues that the EU institutions could explore in order to avoid repetition of the unfortunate Fedon-experience in the future.

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