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**FTAs as Applicable Law in WTO Dispute Settlement:  
Was the Appellate Body Wrong in Peru-Additional  
Duty (DS457)?**

Gregory Shaffer and L. Alan Winters



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## **Abstract**

There is a serious imbalance between the sclerosis of the political system of the World Trade Organization (WTO) and the automatic adoption of WTO Appellate Body judicial reports. The question is whether the WTO Appellate Body will recognize bilateral political agreements (such as under Free Trade Agreements, FTAs) that modify WTO obligations between two parties. In addressing this question, the Appellate Body decision in *Peru-Additional Duty on Imports of Certain Agricultural Products* is important. The decision addressed the availability of defenses under FTAs in WTO disputes, as well as under public international law generally. After critically assessing the decision, we set forth a series of judicial and political choices for addressing the interaction of WTO and FTA rules going forward. In particular, we contend that clear modifications of WTO commitments under an FTA should be recognized by WTO panels as a defense, but subject to the FTA itself complying with WTO requirements under GATT Article XXIV. The case is important not only for trade specialists, but generally for policymakers and scholars of global governance in a world of fragmented international treaties.

## **Keywords**

WTO, FTAs, variable levies, fragmentation.



## Introduction\*

The case *Peru-Additional Duty on Imports of Certain Agricultural Products*, brought by Guatemala, is among the most important cases before the World Trade Organization (WTO) in recent years. More mundanely, the Appellate Body decision addressed the consistency with WTO rules of Peru's Price Range System (PRS) (*Sistema de Franja de Precios*) for four categories of agricultural products (milk, maize, rice, and sugar), pursuant to which Peru's tariffs could vary fortnightly as a function of historical world prices. More systemically, since Peru and Guatemala agreed in a bilateral Free Trade Agreement (FTA) that "Peru may maintain its Price Range System," the Appellate Body decision addressed the interaction of WTO law with FTA rules, as well as public international law generally. The FTA provided, "in the event of any inconsistency" between WTO rules and FTA rules, the FTA rules "shall prevail." The case is important not only for trade specialists, but also for policymakers and scholars of global governance in a world of fragmented international treaties and institutions.

The WTO as a multilateral negotiating forum has become largely dysfunctional while trade negotiations and agreements proliferate in other bilateral and plurilateral venues, such as the Peru-Guatemala FTA. In consequence, clarifying the relation of these trade agreements with WTO rules, as interpreted through the WTO's dispute settlement mechanism, is critical. There is a serious imbalance between the sclerosis of the WTO's political bodies and the automatic adoption of WTO Appellate Body reports. This imbalance is brought to light where the Appellate Body interprets the meaning of ambiguous provisions, and the losing party then challenges its authority by accusing it of illegitimate judicial activism and "gap filling," especially when the losing party is a powerful country such as the United States (U.S.). Such a situation could undermine confidence in the WTO, including its so-called "crown jewel," the WTO dispute settlement system, which has been uniquely authoritative as an international tribunal at the multilateral level, but whose authority appears to be at risk (Shaffer, Elsig and Puig 2016; Elsig, Pollack and Shaffer 2016).

Some form of political process is needed to update international trade rules, which were set in 1994, and, where necessary, clarify their meaning in light of ongoing disputes and controversy over Appellate Body interpretations. Since the political negotiation over trade rules is blocked in the WTO, it has moved to bilateral and plurilateral forums. As of January 1, 2016, there were 419 such bilateral and plurilateral agreements in force, with others being negotiated. Where WTO Members modify trade rules that apply between them, or clarify their view of the rules' meaning through bilateral and plurilateral agreements, what will be the response of the WTO Appellate Body? In *Peru-Additional Duty*, the Appellate Body gave guidance, the most to date, regarding its views, raising critical questions and concerns.

As Robert Hudec (2000) wrote, GATT and WTO prescriptions about tariffs are not about "chastity," since they permit protection in the form of tariffs so long as the tariffs do not exceed a WTO Member's tariff binding as set forth in its tariff schedule. WTO Members generally have agreed to bind their tariffs at much higher rates for agricultural products than for industrial ones. In fact, the average bound rate for agriculture tariffs was 107% for India, 106% for Colombia, 98% for Turkey, and 16% for the European Union (E.U.) – Finger, Ingco and Reincke (1995). Peru had high bound rates, including a rate of 68% (from 2004) for the four categories of products at issue. Because Peru wished to liberalize its agricultural markets to a greater extent, subject to use of the PRS mechanism to

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stabilize agricultural prices, it reduced its applied rates to 0%. The PRS was subject to Peru's commitment that the applied tariff rate would never exceed Peru's bound rate.

Chile earlier applied an analogous scheme that the WTO Appellate Body found to be inconsistent with WTO rules in the *Chile-Price Band* (2002, 2007) cases, so that it was clear that Peru's system could be subject to challenge. Peru, however, designed its PRS in a manner that was somewhat different than Chile's, providing a possible defense under WTO rules. In addition, Peru negotiated FTAs with all of its major trading partners who arguably consented to the use of the PRS under the FTA in question. In 2011, Guatemala and Peru signed one of those FTAs, and Guatemala ratified it. When world prices dropped so that the application of Peru's PRS increased the effective Peruvian tariff applied to certain Guatemalan products (namely sugar), Guatemala initiated a WTO complaint. Peru responded by refusing to take the final step of ratification (which only required the President's proclamation) so that the FTA never went into effect.

The WTO case thus involved two central issues. The first concerned whether Peru's PRS violated WTO rules, namely because it constituted a "variable import levy" or "minimum import price" in violation of Article 4.2 of the WTO Agreement on Agriculture, or an "other duty or charge" in violation of Article II:1(b) of the General Agreement on Tariffs and Trade (GATT) 1994. At first glance, this first issue was easy. The panel and Appellate Body simply applied the Appellate Body's earlier jurisprudence in *Chile-Price Band* to a related set of facts. In doing so, it clarified how to approach and analyze price range systems under WTO rules. Yet, as Bagwell and Sykes (2004) wrote in their analysis of the *Chile-Price Band* decision, it is not patently clear if the Appellate Body was correct given the ambiguity of the text interpreted, which we revisit in this paper from an economic and a legal perspective.

The second issue concerned the relation of these WTO rules to the 2011 FTA between Peru and Guatemala that permitted Peru's price range system. This second issue has become critically important. It poses the question of which rules apply in a defense before the Appellate Body: the Appellate Body's interpretation of WTO rules in clinical isolation of the FTA, or WTO rules in light of the parties' agreement in the FTA? The answer to that question implicates the following fundamental institutional question: who decides, a bilateral political process or a multilateral judicial one that ignores such political process (Shaffer & Trachtman 2011)?

This paper critically analyzes the Appellate Body ruling on these two issues. Part I addresses the economics and political economy of price range systems for agricultural products generally and the operation of Peru's system in particular. It first examines the variable import levies and minimum import prices that the E.U. earlier applied, which spurred intensive negotiations during the Uruguay Round, giving rise to the Agreement on Agriculture. It then assesses the Appellate Body's interpretation of WTO rules applied to Peru's PRS. Part II examines Peru's negotiation of the 2011 FTA with Guatemala and the Appellate Body's treatment of the relation of the FTA to WTO rules. The Appellate Body could have simply followed the panel in finding that the FTA's rules did not apply because the FTA never went into effect. Rather, the Appellate Body assessed the applicability of the FTA's rules regardless of the FTA's status, raising systemic questions of trade governance. After critically assessing the Appellate Body decision, we set forth a series of judicial and political choices for addressing the interaction of WTO and FTA rules going forward. In particular, we contend that clear modifications of WTO commitments under an FTA should be recognized by WTO panels, but subject to the FTA itself complying with WTO requirements regarding FTAs under GATT Article XXIV.

## **I. The WTO Legality of Peru's Agricultural Price Range System**

There are policy trade-offs with agricultural tariff schemes aimed at stabilizing prices. On the one hand, as Saggi and Wu (2016) show, under a simple neoclassical economic model, stabilising duty-inclusive import prices is harmful to a small open economy in economic welfare terms. On the other hand, they note that, in more complex models with frictions in factor markets, a lack of insurance markets and risk aversion, there may be benefits. They contend that trade intervention nonetheless is not the optimal policy, but this conclusion is subject to assumptions regarding the efficient functioning of tax collection and redistribution systems, which assumptions are questionable, especially in poorer countries. Moreover, the short-term attractions of stabilising internal prices through a PRS are fairly clear: no one likes uncertainty and change (we incur considerable costs to avoid it). This view applies particularly to agriculture, and particularly agriculture in poorer countries, in which the returns to fixed assets (land) are important, production decisions have to be taken well in advance of sale, and many producers are poor (at least relative to others in the same country). It is also true of food prices because food takes such a major share of poor people's expenditure and so fluctuations have major effects on their real incomes. Stable prices are even attractive to importers: they know precisely what they will have to pay even if they do not know what goes to the exporter and what to the government. Stabilisation policies thus seem to be a triple win. The long-run attractions of attempting to stabilise prices nonetheless are less clear because, as the world changes, fixed prices get further out of line and eventually impose severe distortions on an economy. Promises to update them regularly to prevent such distortions are not always credible, not least because doing so undermines the very stability they aim to preserve. The use of price range systems thus has an economic rationale in some circumstances, but these systems shift the burden of volatility onto other countries and undermine the predictability of the import taxes faced by foreign traders, and so impose costs abroad. Countries thus have reasons to adopt international rules to address them.

The use by the E.U. of variable levies was an important target for U.S. and other agricultural exporters during the Uruguay Round of negotiations that gave rise to the WTO. We thus start by reviewing the E.U.'s variable levy system (section A), then explain its impact on foreign traders, which helped spur the negotiation of new WTO rules (section B). We then explain Peru's PRS (section C) and assess the panel and Appellate Body rulings on the PRS (section D).

### ***A. Variable Levies in Europe***

Variable levies (VLs) have a long and undistinguished history. Sampson and Snape (1980) trace them back to the early nineteenth century in the British Corn Laws and the French *échelle mobile* of 1819. They slipped into modern policy in the guise of minimum import prices in 1935 in a convention between Belgium and Luxembourg over Benelux's trade policy (Tracy, 1989, p. 244) and into the E.U.'s Common Agriculture Policy (CAP) in the Stresa conference of 1958 (Tracy, 1994).<sup>1</sup> After the latter, VLs became an iconic part of the CAP, which was often viewed as a major achievement in economic integration and a central support for the maintenance of peace in Europe and was, consequentially, viewed as fundamentally non-negotiable.

An important feature of the E.U.'s VL is that it was designed to achieve a fixed internal price (the so-called threshold price), which was fixed annually by policy. The price owed nothing to market forces because the levy was calculated every day to absorb the difference between the cif import price measured at Rotterdam and the politically determined threshold price.<sup>2</sup> The effect of the VLs was thus

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<sup>1</sup> The European Union is the current name of what once was known as the European Economic Community or the European Communities, albeit following an expansion in the membership. We use the modern name throughout.

<sup>2</sup> To ensure that post-duty import prices met the threshold price precisely, one might think of determining the levy transaction by transaction, but that is so open to manipulation by traders that it is impracticable. Like the PRS, the E.U. scheme also made some adjustments for trade costs, but these did not change the principle.

to fix almost completely the duty-inclusive prices of imports and thus those faced by European producers and consumers of the affected products. Because the threshold price was high for a long period, the E.U. switched from being a net importer of some products to self-sufficiency and then to being a net exporter. The E.U. provided variable export subsidies as a complement to help maintain the high internal prices. The E.U.'s export subsidies particularly aggravated trading partners (especially the U.S.), even more than the VLs on imports. On a few occasions (although rarely), the world price exceeded the E.U. threshold price, in which case the E.U. taxed exports and subsidised imports (Pelkmans, 1997). As a result, except for the variation within the space of a day, the E.U. system combining variable levies and subsidies completely fixed E.U. internal prices.

### ***B. The External Impact of Variable Levies and the Negotiation of WTO Rules.***

While the E.U.'s variable levies had mixed benefits for the E.U., almost every other country in the world disliked them. First, they insulated European markets entirely from any developments in the rest of the world and to some extent from those in Europe itself. Consequently, European actors did not adjust to external shocks, with the result that all of the burden of such adjustment fell on non-European actors. That is, VLs may have achieved price stability in the E.U., but at the expense of exacerbating volatility elsewhere.

To see how a variable levy shifts adjustment and uncertainty to the world market, imagine a simple world in which the domestic economy imports a commodity from the rest of the world. Denote the domestic country's demand, supply and price as  $qd$ ,  $qs$  and  $p$  respectively and the world's as  $QD$ ,  $QS$  and  $P$  respectively. Global equilibrium requires that domestic excess demand (imports) equals world excess supply (exports). Assume initially that home levies a specific duty of  $t$  on imports.<sup>3</sup> Assuming linear functions and positive parameters, we can write an uber-simple model:

$$\begin{aligned} qd &= a - bp \\ qs &= c + ep \\ QD &= A - BP \\ QS &= C + EP \\ p &= P + t \end{aligned}$$

The parameter  $a$  is the level of demand if the price were zero and  $b$  describes the way in which demand falls from that level as the price rises.  $A$  and  $B$  play exactly the same role for the rest of the world. Similarly,  $c$  tells us supply if the price were zero and  $e$  the way in which it increases as price rises, and  $C$  and  $E$  act similarly for the rest of the world. Equating  $(QS-QD)$  and  $(qd-qs)$ , and substituting for  $p$ , the world price is:

$$P = \frac{(a-c)+(A-C)-(b+e)t}{(E+B)+(b+e)}. \quad (1)$$

Provided that  $A > C$  and  $a > c$ , the conditions for the demand and supply curves to intersect at positive quantities in the two markets, the world price is positive. Positive shocks to demand (i.e. increases in  $A$  or  $a$ ) increase it while those to supply (to  $C$  and  $c$ ) decrease it, as does an increase in the tariff ( $t$ ).

Now replace the specific duty by a variable levy which fixes the domestic price at an exogenously given level,  $p^*$ . The expression for the world price now becomes

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<sup>3</sup> The comparison between a duty and a variable levy is easier to conceptualise in terms of specific duties because the variable levy adds a specific amount to the import price to bring it up to the required threshold price. The same idea holds for an ad valorem duty, but the algebra is slightly messier.

$$P = \frac{(a-c)+(A-C)-(b+e)p^*}{(E+B)}. \quad (2)$$

Because  $(b + e) > 0$ , any shock to the underlying supply and demand functions will have a greater effect in (2), i.e. under a variable levy, than in (1), under a specific duty.<sup>4</sup> From the basic functions, a larger shock to P implies larger shocks to *QD* and/or *QS*.

The second objection to VLs was that E.U. threshold prices were set so high that VLs implied a high level of protection – with a consequent loss of market access for efficient producers outside Europe. In fact, perhaps because the protection was not as obvious as with a tariff, VLs ended up conferring huge levels of protection in many E.U. agricultural markets. A third objection was that, at the level of individual transactions, an exporter facing a VL loses much of the incentive and ability to innovate to increase his/her exports. If an exporter manages to reduce her cost and hence price, that reduction is absorbed into the levy the *very next day*, so that there is no expansion of overall demand. It is true that the exporter may be able to increase her market share at the expense of other exporters, but this is an unattractive zero-sum game which exporting countries have very little interest in pursuing or even permitting. That is, VLs stultify competition.

The E.U. is obviously large enough to impose material costs on its trading partners via both the terms of trade effects of protection and the transmission of instability. In contrast, if a small country such as Peru were guilty of such behaviour, its effect on the rest of the world would be correspondingly small and therefore may not be worth contesting. However, first, even a small economy may be large to one of its neighbours if the latter depends heavily on it for trade. Second, if every small country behaved in this way, the effects would add up to something significant. Third, even violations by insignificant players can undermine the credibility of the system and thus increase the chances that larger players will transgress. Peru fits this situation – it is not large enough to impose serious costs on the vast majority of trading nations - but given the almost iconic status of variable levies in the struggle to create the WTO it might be felt that to allow one to pass unchallenged was a step too far.

The frictions over agriculture between the U.S. and the E.U. are well documented (Josling and Tangermann, 2015) and variable levies were a major part of them. In the Uruguay Round of trade negotiations, the U.S. aimed to eliminate agricultural protection, and from an early date pressed the case for ‘tariffing’ all trade barriers other than ordinary customs duties - i.e. converting them into tariffs of the same protective effect - and then gradually reducing those tariffs to zero. The Round nearly came to grief several times over agriculture, but at the last moment agreement was reached, including to tariff non-tariff barriers and then reduce (but not eliminate) the tariff rates they implied.<sup>5</sup>

This agreement was incorporated into the Agreement on Agriculture, Article 4.2 of which prohibited “...measures of the kind which have been required to be converted into ordinary customs duties...” with its ostensibly clarificatory footnote that these “include ... variable import levies, minimum import prices, ... and similar border measures...”. For our purposes, two aspects of the agreement are of note. First, the degree of tariff liberalisation achieved was actually rather small and as early as 1995, commentators were claiming that the Round’s main achievement in agriculture was not that it had reduced trade barriers but that the system had been rationalised and that through tariffication the means to future liberalisation had been secured: see Hathaway and Ingco (1995, p. 58),

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<sup>4</sup> The denominators are different in equations 1 and 2 because when there is a fixed tariff, both foreign and domestic markets adjust to shocks - via (B and E) and (b and e) respectively - whereas when there is a (perfect) variable levy, the domestic market does not adjust, so only foreign flexibility (B and E) operate. This difference captures precisely the fact that for a given shock - to, say, A - the foreign price changes more because there is no change in the domestic price to get the domestic market to adjust.

<sup>5</sup> The negotiations over agriculture are summarized in greater detail in the Appendix, part A, from which the following paragraphs draw.

or Josling, Tangermann and Warley (1996, p. 218) who write, the Uruguay Round's accomplishment of "tariffication of import barriers in agriculture... [was] a quantum leap forward in the long process of bringing agriculture fully into the realm of the GATT." If this was all that seven years' hard politicking had produced, it is easy to see why trade officials, especially those from the WTO and the agricultural exporting nations, became so wedded to the principle of tariffication and the elimination of variable levy and minimum import price schemes.

The second aspect of note is that, as we discuss below, Article 4.2 is ambiguous because 'of the kind' is not precise and the footnote is only illustrative (it says 'include'). However, one can arguably see the intent of the negotiations because the staff document issued immediately after the Agreement was signed to guide its implementation – the so-called 'Modalities', (MTN.GNG/MA/W/24) – states in Annex III, Section A, paragraph 1:

"The policy coverage of tariffication shall include *all* border measures other than ordinary customs duties *such as*: quantitative import restrictions, variable import levies, minimum import prices, ... and any other schemes similar to those listed above, ...." (Emphasis added)

Although the Modalities provide that they "shall not be used as a basis for dispute settlement proceedings" (p. 1), the text makes clear the expectation that everything other than "ordinary customs duties" was liable to tariffication.

### ***C. Peru's Price Range System***

There are clear differences between the E.U.'s system of VL's and Peru's PRS. In practice, Peru's PRS determines the internal price much less closely than the EU's VL system, and is thus much more subject to market forces. Unlike the E.U.'s VL system, moreover, the PRS was subject to a commitment that Peru's applied tariff would never exceed its bound rate. Many Latin American officials were of the view that price range systems, as that used by Peru, were legal so long as the applied tariff did not exceed the tariff binding in its schedule. In fact, the Economic System of Latin America (SELA) apparently sought and received assurance from GATT officials that as long as PRS-like policies resulted in a tariff below the bound level, there was no problem, although we have seen no supporting documentation.<sup>6</sup> Thus, the question arises whether Peru's tariff binding, combined with its PRS, was sufficient to comply with Peru's WTO undertakings. Were the differences between the E.U.'s system of levies (varying by day based on a fixed threshold price, and not subject to a tariff binding), and Peru's PRS large enough that the PRS would not be considered a variable import levy or minimum import price inconsistent with WTO rules on tariffication? Table 1 offers a comparison between the E.U.'s VL system and Peru's PRS, which we further explain below.

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<sup>6</sup> Email from Alejandro Jara, former Ambassador of Chile to the WTO, and Deputy Director General of the WTO. Article 5 of the Agreement on Agriculture permits countries to exceed their tariff bindings for agricultural products they have 'tariffied' under certain conditions and provided they have reserved the right to do so in their tariff schedules. The fact that Peru did not reserve this special safeguard right regarding the four categories of agricultural products in question might be viewed as providing some support for the claim that it understood that the PRS was considered already to constitute an ordinary customs duty and thus was not required to be eliminated. Josling, Tangermann and Wartley (1996, pp. 190-191) noted that Latin American price band policies "could potentially still be considered an 'ordinary customs duty,'" but warned that "issues may well arise as to [their] GATT-legality."

**Table 1. A comparison between the E.U.’s Variable Levies and Peru’s PRS**

Dimension	E.U.’s Variable Levies	Peru’s PRS
Target price	Internal price set by policy	Long-run average on world market
Reference price based on	Imports into EU	Sales on the world market
Frequency of fixing	daily	fortnightly
Applied to which commodity	Just the commodity in question	Duty from marker products extended to associated products
Duty capped at binding?	No	Yes
Import subsidies?	Yes	No
Export subsidies/taxes?	Yes	No
Achieves minimum import price?	Almost certainly	Less certainly unless Peru’s import prices mirror world prices precisely.

Peru’s PRS covers 45 agricultural products, separated into four general categories: milk, yellow maize, rice, and sugar.<sup>7</sup> Within each category, one tariff line is designated a “marker” product and all others as “associated” products. Floor and ceiling prices are determined for each marker product on the basis of the monthly average f.o.b. (freight on board) prices for the past 60 months on the international reference market for that marker product corrected for U.S. inflation. These prices are updated semi-annually and converted into c.i.f. (cost, insurance and freight) floor and ceiling prices.<sup>8</sup> In addition, a reference price for the marker product is calculated every two weeks as the average international market price for the product over the preceding two weeks, also converted to c.i.f terms.<sup>9</sup>

Whenever the international reference price,  $p^R$  falls below the floor price,  $p^F$ , a variable additional duty is levied on the imported good to bring its price up to the floor level. Letting  $b$  denote an allowance for the import costs associated with marker products, the additional variable duty  $AD$  is given by:

$$AD = (1 + b) (p^F - p^R) \quad (3)$$

This prevents low import prices from being passed onto Peruvian farmers and consumers. When, on the other hand, the reference price is above the ceiling price,  $p^C$ , a tariff rebate is issued to the importer to bring the net price down to the ceiling level. It equals:

$$TR = (1 + b) (p^R - p^C) \quad (4)$$

This serves to protect Peruvian consumers from undesired price increases on the global market.

The declared objectives of Peru’s PRS were to foster price stability, counter the adverse effects of price distortions in international markets, and improve domestic competitiveness. In the words of the PRS, they were:

<sup>7</sup> For a complete list at the HS-10 level, see Panel Report., para. 7.121. See Saggi and Wu’s (2016) for an earlier description and assessment of the PRS.

<sup>8</sup> Ibid., paras. 7.127-7.135. In addition, for sugar the prices are increased by 44.1% of the floor price between September 2002 and January 2006 and by 10.7% of the floor price thereafter – Ibid. para 7.131.

<sup>9</sup> Ibid., paras. 7.136-7.139.

to counter the adverse effects to domestic agricultural production on account of “distortions . . . due, in particular, to the agricultural policies implemented by the main food producing and exporting countries” and as “reflected in the uncertainty and instability of domestic prices”<sup>10</sup>;

to provide “a stabilization and protection mechanism that makes it possible to neutralize the fluctuations of international prices and limit the negative effects of the fall in those prices”; and

to provide “an appropriate means of improving the levels of competitiveness of domestic producers, by giving the market clear signals with regard to trends in prices, thereby allowing economic agents to operate efficiently and productively . . . .”<sup>11</sup>

The PRS purports to stabilize prices in the short run and offer an element of protection to farmers by pegging local prices to world prices over the long run.<sup>12</sup>

Our first question is: did the actual design of Peru’s PRS achieve the stated objectives, initially for the marker products and subsequently for the associated products as well? Even for the marker products, the PRS’s stabilisation is incomplete and its protection somewhat covert and arbitrary. As just noted, the system is anchored to the long-run mean world price of the marker products from which we infer that the long-run price is in some sense an objective and hence an appropriate bench-mark against which to measure the PRS’s performance. A price-band scheme aimed purely at stabilisation would allow prices to vary within a band around the mean price ( $\mu$ ), with more extreme fluctuations in either direction curtailed according to equations (3) and (4) above. The band in the PRS is set equal to the standard deviation of world prices measured over the five year anchor period ( $s$ ), but instead of spanning the mean price such that the range is  $(\mu - s/2)$  to  $(\mu + s/2)$ , it rests on the mean price, giving a range of  $\mu$  to  $(\mu + s)$ . To a first order approximation, this design feature rules out local prices ever falling below the long-run world mean and results in the mean duty-inclusive import price being about  $s/2$  above the mean long-run world price  $\mu$ .<sup>13</sup> The value of  $s$  clearly depends on the variability of the reference prices over the preceding five years and so it is both variable and uncontrollable. Over our sample of data – see below –  $s$  ranges from 7.5% of the long-run world mean price (for dairy products over early 2002) to 47.2% (for rice in 2010), so the price-raising effect of using the long-run price as a minimum rather than an average is to increase average prices by around 3.7% to 23.6%.

The Peruvian PRS has two other modifications relative to a simple price band. First, as noted above, the additional duty under the PRS was capped so that the sum of the additional duty, the *ad valorem* tariff (of 0% after 2010), and (while it lasted) an import surcharge did not exceed the *ad valorem* rates bound under the Uruguay Round. Peru’s bound rates for the four marker products, in fact, were quite high, so that Peru’s applied tariffs never exceeded and almost always remained below them: 68% for all four categories from 2004 onwards.<sup>14</sup> Peru set an additional surcharge at 5% until 2007 and then abolished it.

The second modification is that when prices exceed the ceiling price, Peru caps the rebate it provides importers to the total level of duties (*ad valorem* and surcharge) they paid. Because Peru liberalized its agricultural trade through low applied rates (eventually set at zero), this restriction considerably constrains the PRS’s ability to mitigate the transmission of increases in world prices and

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<sup>10</sup> It is, of course, likely that any such distortions will have affected the floor and ceiling prices as well.

<sup>11</sup> Ibid., para. 7.118.

<sup>12</sup> There is also a brief genuflection towards consumers – Panel Report para. 7.119 – but it is clearly secondary to the producer interest.

<sup>13</sup> The precise amount of the uplift depends on the distribution of the reference prices over the range  $\mu$  to  $(\mu + s)$ .

<sup>14</sup> In the Uruguay Round developing countries agreed to reduce their so-called base tariffs in ten equal annual steps starting in January 1995. Thus between 2001-2004 Peru was committed to reduce base tariffs from 103% for rice, 90% for maize, 87% for sugar, and 77% for dairy to the bound rate of 68%.

imparts a significant upward bias to the average duty-inclusive import price.<sup>15</sup> With an applied tariff rate at zero, the PRS only served to increase Peru's applied tariffs, not to reduce them, giving rise to no additional benefits to consumers.

The effects of these adaptations of the simple price-band model on the degree of price protection and stabilisation for the four marker products are shown in Table 2. We define protection as the mean percentage excess of the price resulting from the policy intervention over the long-run mean world price and stabilisation as the root mean square of the percentage change in the price from one fortnight to the next<sup>16</sup>. As described in Appendix part B, the calculations are conducted on data from June 2001, the start date of the PRS, to September 2013, essentially the same data used by the Panel in its consideration of the PRS.

**Table 2. Mean deviations from long-run world mean price and fortnightly variability – four marker products**

	1	2	3	4
	reference price	centred range	PRS actual range	PRS with caps
dairy: whole milk in powder, no added sugar, 0402 21 19 00				
Mean	15.0%	3.2%	8.7%	15.5%
RMS(%Δ)	3.6%	2.7%	3.2%	2.9%
maize: No. 2 yellow maize, 1005 90 11 00				
Mean	26.4%	5.8%	12.6%	22.9%
RMS(%Δ)	4.7%	3.3%	3.6%	4.2%
rice: white rice, 1006 30 00 00				
Mean	13.7%	3.7%	11.4%	19.7%
RMS(%Δ)	3.7%	2.3%	2.4%	3.6%
sugar: refined white sugar 1701 99 00 90				
Mean	23.3%	1.1%	28.5%	35.4%
RMS(%Δ)	4.6%	3.8%	3.4%	4.3%

Since the price range system is anchored on the five-year average of the reference price (updated every six months), Table 2 reports the mean percentage deviation of the adjusted price from this target and also the root mean square of the percentage change in price from one fortnightly period to the next [RMS(%Δ)]. Column 1 reports the deviations for the reference prices themselves – i.e if there were no PRS policy at all - which shows that *over this sample*, world prices were on average well above the

<sup>15</sup> In addition, as noted above, the prices used in the calculations are also modified by a cif-fob adjustment and an allowance for the cost of importing the marker product, but neither imparts any significant bias or changes the basic principles of the PRS.

<sup>16</sup> Protection is the  $(p_t^p - p_t^{WL})/p_t^{WL}$  averaged over the whole period where  $p_t^p$  is the policy-determined price for fortnight  $t$  and  $p_t^{WL}$  is the world long-run price for fortnight  $t$ . Stabilisation is the square-root of the average over the whole period of  $[(p_t^p - p_{t-1}^p) / p_{t-1}^p]^2$ .

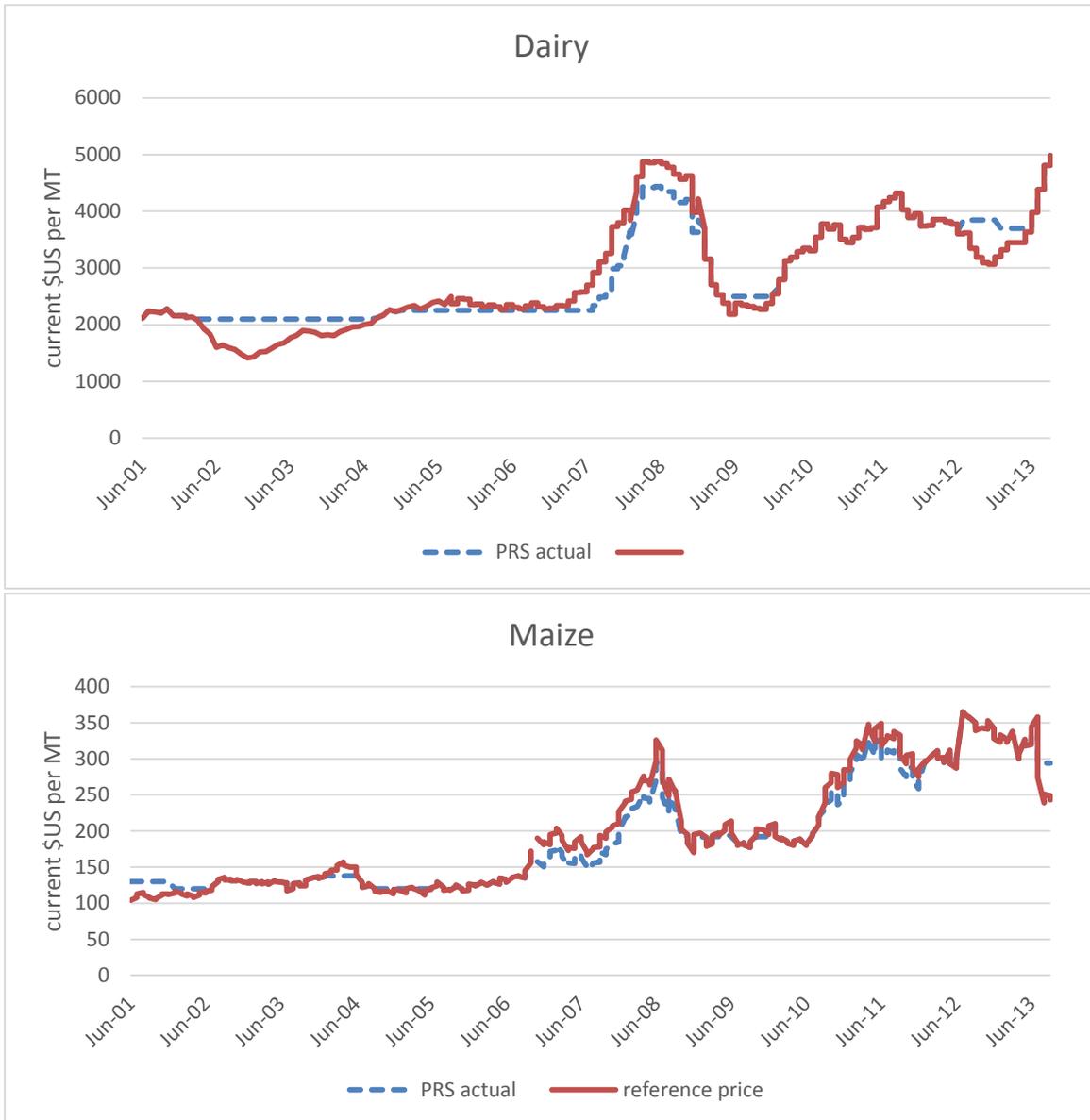
target and that they displayed considerable variability – 3.6% to 4.7% per fortnight. Column 2 considers a pure price range system centered on the target mean price. Even here, because of the way that prices are distributed within the band, the mean deviation is positive, but not substantially so. Thus a centered PRS would have induced a considerable reduction in the mean price relative to the reference price by bringing the very high prices of the period 2005-08 down to the ceiling price and also reduced fortnightly changes. Column 3 considers the PRS's actual range but with no caps or limits on its application, while column 4 adds in the effect of the caps on the *ad valorem* equivalent and the tariff rebate, and so is as close as we get to what actually happened. Because the reference price was at times above the ceiling price and the applied *ad valorem* tariff was eventually set at zero, Peru eventually granted no rebates. This lack of a rebate explains why the mean price is so much higher in column 4 than in column 3. It also served to increase the fortnightly variability in three of the four commodities, because the post-duty price fluctuated with the reference price rather than being pinned to the ceiling price; the exception is milk for which there was a 47% hike in the ceiling price in July 2008, so that if the rebate had not been capped there would have been a huge jump in the policy-adjusted price, whereas the absence of an effective rebate had prevented the PRS from keeping the price down in the preceding period. Figure 1 compares the reference prices and those emerging from the PRS for the four products.

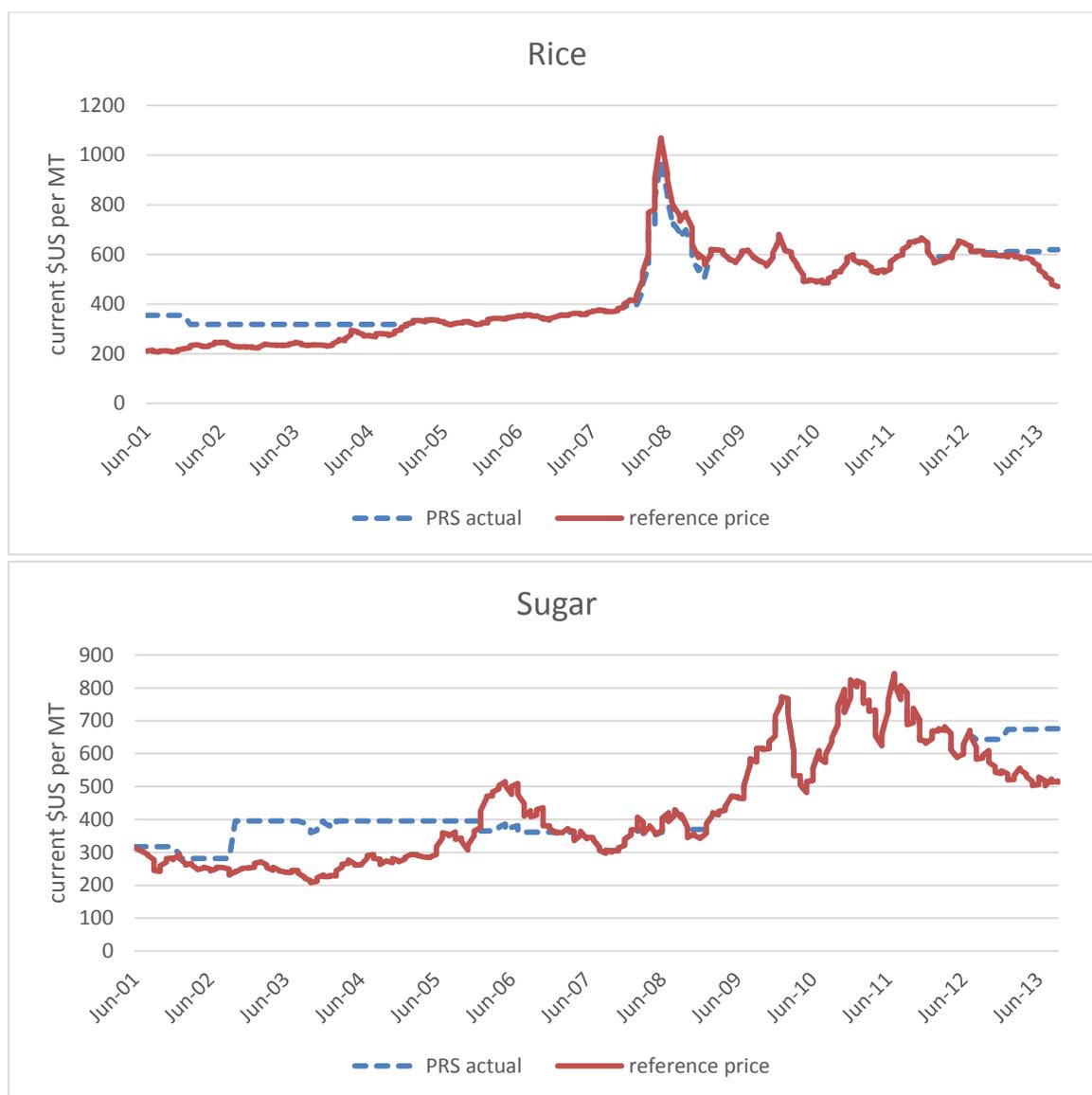
If the Peruvian authorities were truly aiming to replicate the (long-run) world average prices for the four market products and to reduce price variability about them, a centered PRS would do this quite effectively. However, by grossing up the sugar price, rebasing the PRS to rest on the mean and by limiting rebates to the duties paid (for which there were none once applied rates were set at zero), the PRS design created a substantial positive bias to mean prices and generally increased variability. In three out of the four products, the mean price induced by the actual PRS exceeds that of the reference price (compare columns 4 and 1) and for none of them is variability reduced by more than a quarter. Thus, as it turned out, the PRS's design delivered more by way of protection than by way of stabilization (again because the applied rates otherwise were set at zero). It functioned to protect farmers from low world prices while allowing them to benefit from high world prices, as Figure 1 makes clear.

The objective of protecting farmers from low prices is particularly salient for sugar, which is the only PRS commodity for which, according to Saggi and Wu (2016), Guatemala exported significant amounts to Peru. The FTA negotiations between Guatemala and Peru were initiated under a protocol agreed in October 2010 and the agreement was signed in December 2011. At both times, the reference price exceeded the PRS ceiling price so that no additional duties applied. By August 2012, however, the reference price had fallen below the PRS floor price and Peru levied 'additional variable duties' on sugar, which rose to about 25% by April 2013, when Guatemala sought WTO consultations about the PRS, and by 30% by September 2013, when the WTO panel was formed. This world price change and its effect under the PRS explains why Guatemala faced less producer pressure when signing the FTA in 2011, and why producer pressure likely induced Guatemala to bring the WTO complaint in 2013.

Our analysis so far concerns just the four marker products and their prices averaged over periods of a fortnight. In fact, prices fluctuate within the fortnight so the short-run stabilization is less than indicated above, although probably only trivially. More significant is that while the PRS is anchored to the long-run mean world price, the prices of imports of the marker products into Peru may well differ. Systematic differences will affect the degree of protection that the PRS actually provides in Peru (it will be lower if Peruvian import prices persistently exceed world price). For the associated products, the PRS's stabilizing and mean-raising properties will similarly depend on the extent to which their prices parallel those of their relevant marker products.

**Figure 1: Reference Prices and Post-PRS prices: four marker products**





In sum, although not nearly as protectionist as the E.U.’s earlier system of variable levies and minimum import prices, the design of Peru’s PRS arguably provided more protection than stabilization of prices. Moreover, Peru’s tariffs could and often did vary on a fortnightly basis, opening them to a WTO legal challenge that they were variable import levies in contravention of WTO rules. Although WTO rules permit countries to negotiate agricultural tariff bindings at high levels, they prohibit the use of variable import levies for agricultural products, regardless of the tariff rate, as we will see.

#### **D. The Appellate Body Decision on Guatemala’s PRS Claims**

The first group of WTO legal questions in the case, outside the relation of FTA and WTO rules, were three-fold: (i) whether Peru’s PRS gave rise to variable import levies (or measures similar to them) in violation of Article 4.2 of the Agreement on Agriculture; (ii) whether the PRS involved minimum import prices (or measures similar to them) in violation of that same article; and (iii) whether the PRS gave rise to duties that were not “ordinary customs duties,” but rather “other duties or charges” not listed on Peru’s tariff schedule, in violation of Article II:1(b) of GATT 1994.

The panel and the Appellate Body first analyzed the claims under Article 4.2 of the Agreement on Agriculture because these provisions were more specific (and thus *lex specialis*) in governing the

agricultural tariff scheme. Article 4.2 of the Agreement on Agriculture provides that “Members shall not maintain, resort to, or revert to any measures of the kind which have been required to be converted into ordinary customs duties, except as otherwise provided for in Article 5 and Annex 5.”<sup>17</sup> It is accompanied by a footnote that provides, “[t]hese measures include quantitative import restrictions, *variable import levies, minimum import prices, ... and similar border measures other than ordinary customs duties*” (emphasis added). Implicitly from this text, if an agricultural tariff is either a variable import levy or a minimum import price, then it is not an ordinary customs duty for purposes of the Agreement on Agriculture and the GATT.

The key question was whether Peru’s measures were “of the kind which have been required to be converted into ordinary customs duties.” Since the term “ordinary customs duties” is not defined, and since the agreement does not specify what “kind” of measures were required to be converted other than the non-exclusive list contained in the footnote, the text is not without ambiguity. The panel and Appellate Body thus focused on whether Peru’s scheme was a “variable import levy” or a “minimum import price,” or a measure “similar” to one, which terms are not defined.

This legal issue was straightforward in light of the Appellate Body’s analysis in its 2003 decision in *Chile-Price Band* regarding the meaning of these terms. In that case, the Appellate Body found that Chile’s price band was sufficiently similar to a variable import levy and a minimum import price so as to contravene Article 4.2 of the Agreement on Agriculture. The Appellate Body bolstered its interpretation of the text through addressing “the object and purpose” of Article 4,<sup>18</sup> which it maintained is to enhance “transparency and predictability” of ordinary customs duties<sup>19</sup> in order “to achieve improved market access conditions for imports.”<sup>20</sup> Peru aimed to differentiate its PRS on the grounds that its system was transparent and predictable because the price bands and reference prices were published on the government’s website and the prices changed only every two weeks. For the panel and Appellate Body, however, these changes were not sufficient and they both repeatedly cited the *Chile-Price Band* precedent to find that the duties were “variable.” This finding raises the question posed by Saggi and Wu (2016) in their analysis of the panel decision in *Peru-Additional Duty* as to whether a PRS can be designed to vary less frequently (say once a month, or once every six months) so that it could pass muster under the Appellate Body’s analysis.

That question, however, could be moot in light of the Appellate Body’s suggestion that the PRS gave rise to “minimum import prices.” The panel found that Peru’s PRS did not give rise to a minimum import price because the scheme was built on a reference price based on world prices, and not on individual transaction prices. Peru could thus give examples of individual transactions that were sold at less than the floor price under the PRS without incurring an additional duty because the reference price was still within the band. The Appellate Body, however, reversed the panel’s findings that Peru’s PRS did not result in a minimum import price because the panel failed to properly assess its structure, design, and operation, but rather focused predominantly on the system’s effects. The Appellate Body did not complete the analysis, finding that it did not need to do so given its finding that the PRS gave rise to variable import levies. The Appellate Body nonetheless strongly suggested

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<sup>17</sup> Article 5 covers “special safeguards” indicated on countries schedules for products where measures have been converted into ordinary customs duties (which permits agricultural price stabilization through increased tariffs where prices drop below a world reference price or imports grow above a prescribed rate), and Annex 5 provides for special treatment of certain products (namely rice for certain Asian countries) subject to conditions.

<sup>18</sup> The Appellate Body has generally been very textualist in its interpretations and stayed away from teleological interpretations. See Cook 2015, para. 15.32 (“WTO adjudicators have been wary of certain forms of reasoning by reference to object and purpose, and have generally been cautious about attaching too much weight to the object and purpose of a treaty as a basis for its interpretation”).

<sup>19</sup> AB Report, para. 234.

<sup>20</sup> AB Report, *Chile Price-Band*, Article 21.5, para.149, cited in AB Report, *Peru-Additional Duty*, para. 5.39.

that it could find that the measure was similar to a minimum price import, as it had found in the earlier case against Chile.

As noted above, Peru's system did not involve a classic *de jure* minimum import price requirement — it was based on the world reference price in relation to a five-year average world market price, and not on whether an individual transaction fell below a specified price. However, to the extent that transaction prices in agricultural markets generally tend to track world prices reflected in a reference price, the design, structure, and operation of Peru's PRS could be viewed as "similar" to a "minimum import price." Likewise, although the classic variable import levy of the E.U. varied the levy by the day, as opposed to a reference price that varies every two weeks, the design, structure, and operation of Peru's PRS could be viewed as at least "similar" to a variable import levy in that they duty could (and often did) vary every two weeks, depending on the reference price.

Once the panel and Appellate Body found that the PRS gave rise to a variable import levy, they easily concluded that the PRS was not an "ordinary customs duty" within the meaning of GATT Article II.1(b). The determination of the Article 4.2 claim under the Agreement on Agriculture, in other words, effectively determined the GATT Article II(1)(b) claim because the footnote to Article 4.2 of the Agreement on Agriculture notes "variable import levies" and "minimum import prices" as examples of measures that are not "ordinary customs duties."<sup>21</sup> As a result, both the panel and the Appellate Body found that the tariff measures were "other duties and charges" that Peru had not listed in its schedule, so that Peru also violated GATT Article II.1(b).<sup>22</sup>

There may be good legal grounds to maintain that the design, structure, and operation of Peru's measures are similar to a variable import levy and (possibly) a minimum import price. Yet, given that there is some ambiguity in the text (regarding the definition of variable import levy), given that Peru's applied tariffs were set at zero so long as the reference price fell within the five-year average, given that Peru was authorized to raise its tariffs to 68% (which was its WTO tariff binding), and given that Peruvian policy makers see a rationale for a PRS to provide some stability to agricultural markets for farmers, especially poorer ones who otherwise may be unable to tap into insurance markets, it seems worth seeking a solution. The current situation places stains on the system which, if not resolved through an acceptable dispute outcome or through a mutually agreed settlement, could lead to a Member either raising its tariff bindings in a blunt way to block imports (possibly up to its tariff binding), or defying the Appellate Body. The third alternative, which is an interpretation of what happened here, is that the Member may negotiate a political agreement, such as through a series of FTAs, and ask the Appellate Body to recognize those agreements.

The WTO legal dispute in *Chile-Price Band* on this issue lasted seven years, from October 5, 2000 when Argentina first filed its complaint, until May 7, 2007 when the Appellate Body issued its Article 21.5 ruling that Chile had still not complied with the Appellate Body ruling of September 23, 2002. Chile continues to use a price band subject to its WTO tariff binding, a binding that it renegotiated to increase to 98% for sugar after the WTO ruling.<sup>23</sup> There was, in other words, lots of law, but little

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<sup>21</sup> If the Appellate Body considered the negotiators' intentions as indicated by the Modalities, the determination under Article 4.2 also comes back to the "ordinary customs duty" question. The modalities make clear that *anything* that is not an "ordinary customs duty" was expected to be tariffied regardless of whether it resembled the illustrative policies provided in the footnote.

<sup>22</sup> Article II.1(b) provides: "Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those imposed on the date of this Agreement or those directly and mandatorily required to be imposed thereafter by legislation in force in the importing territory on that date."

<sup>23</sup> Our understanding is that Argentina initiated the dispute because Chile did not honor a political undertaking that it made in relation to a safeguard and price band that gave rise to tariffs above Chile's bound rate. Bringing a claim against Chile's price band was risky for Argentina because, at the time, and perhaps even continuing now, it maintained a price band for sugar. Argentina also knew that Chile could raise its applied rate toward the bound rate of 31.5%, an option that Argentina wished to avoid since Chile's applied MFN rate was (and still is 6%) and the operation of the price band could lower the rate even below the applied rate, much less the bound rate of 31.5%.

action. In the end, the panel and Appellate Body reports had little legal effect, and the two sides moved on.

A similar pattern appears to be developing in response to the Appellate Body decision in *Peru-Additional Duty*. Following the decision, an arbitrator, Ricardo Ramirez, decided that Peru should comply with the decision by March 29, 2016. Peru maintained its PRS, but with reference prices that will now be published monthly.<sup>24</sup> In this way, Peru aims to advance an argument that the PRS is no longer a “variable import levy” (since it only changes monthly), and thus an ordinary customs duty with an applied rate that is less than Peru’s tariff binding. Guatemala may commence an Article 21.5 compliance proceeding that will drag the case through more legal hoops.

The question posed before the Article 21.5 compliance panel will be where to draw the line between an “ordinary customs duty,” which countries can periodically change provided the duty remains beneath the tariff binding, and an “other duty or charge” in the form of a variable import levy which is prohibited. The answer is not obvious, especially if the stated goal of the Agreement on Agriculture is to provide greater predictability for traders. If Peru replaces its PRS with a system of periodically changing its ordinary customs duty through an administrative decision, the changes would be less predictable for traders. At the end of the day, the Appellate Body’s legal ruling, as that in *Chile-Price Band*, may be largely ignored or its effect undercut through other means, such as through a general safeguard measure, or by periodically raising the applied tariff rate. The political salience for Peru appears simply too great, as reflected in Peru’s efforts to sign FTAs with its major trading partners regarding the PRS.

## **II. Peru’s Defense: Relation of the FTA to WTO Rules in a WTO Dispute**

Had Guatemala not signed an FTA with Peru, our analysis would be complete since the only issue would have been whether Peru’s PRS violated WTO rules, as the Appellate Body found. Our analysis would likewise be complete if a different WTO Member had brought the complaint, one that had not signed an FTA that permitted Peru to maintain the PRS. As shown above, variable levies impose costs on foreign traders by shifting the burden of price volatility abroad and by undermining the predictability of import taxes, and the WTO’s Agreement on Agriculture bans them. Finally, since Peru never ratified the FTA so that the FTA never went into effect, there would be much less to assess had the Appellate Body not decided the case “irrespective of the status of the FTA as not being ratified by both parties.”<sup>25</sup> It was because none of the above was the case, and particularly because of the breadth of the Appellate Body’s ruling, that the *Peru-Additional Duties* case has significant implications for global trade governance.

The ability to use a PRS for this set of products (milk, maize, rice, and sugar) is politically salient for Peru. Between 2005–2015, Peru signed at least fifteen FTAs covering fifty WTO members: Australia, Brunei, Canada, Chile, China, Colombia, Costa Rica, the EFTA states, the European Union (and its member states), Guatemala, Honduras, Japan, Malaysia, New Zealand, South Korea, Mexico, Panama, Singapore, Vietnam, and the United States, in which these WTO members accepted Peru’s PRS. Peru negotiated such acceptance most recently under the Trans-Pacific Partnership (TPP) mega-regional, and thus including with the U.S. in the event it ratifies the TPP (for FTA texts, see Annex 1, Saggi and Wu 2016).<sup>26</sup> The WTO Appellate Body may have found that Peru’s PRS was unacceptable

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<sup>24</sup> See Normas Legales, Decreto Supremo No. 055-2016-EF, available at <http://www.elperuano.com.pe/NormasElperuano/2016/03/28/1360415-1.html> (Articles 4 & 7). In addition, Peru capped the tariff at 20%. See Normas Legales, Decreto Supremo No. 103-2015-EF, available at <http://www.elperuano.com.pe/NormasElperuano/2015/05/01/1232225-3.html> (Article 2).

<sup>25</sup> AB Report, paras. 5.106, and para. 5.28.

<sup>26</sup> The TPP is not as clear as the Guatemala-Peru FTA and the other FTA texts, but nonetheless accepts Peru’s PRS. The TPP provides that for the products in question, Peru’s customs duties shall be as follows: “(i) the *ad valorem* duty shall

under WTO rules; but Peru negotiated specific rules accepting the PRS with all of its most important trading partners, covering over 95% of Peru's trade.

In the case of the Peru-Guatemala FTA, Guatemala agreed that "Peru may maintain its Price Range System established in Decree no. 1152001EF." The FTA also addressed the issue of inconsistencies between the FTA and WTO agreements. Although, in the first paragraph of FTA Article 1.3, the parties "confirm their existing mutual rights and obligations under the WTO Agreement and other agreements to which they may be parties," the second paragraph clarifies that, "[i]n the event of any inconsistency between this Treaty and the agreements referred to in paragraph 1 [such as the WTO Agreement], this Treaty shall prevail to the extent of the inconsistency, unless otherwise provided in this Treaty."

The critical question is: what is the relation of FTA provisions as a defense to WTO rules? Will the WTO Appellate Body address and recognize bilateral agreements, such as that between Peru and Guatemala, or will the Appellate Body be an obstacle to them? In public international law, in the event of a conflict between provisions in two agreements, two canons of interpretation help resolve it. One is the rule of *lex posterior*, codified in Article 30(3) and (4) of the Vienna Convention of the Law of Treaties (Vienna Convention), which provides that a later-in-time rule prevails over the earlier one. The other is the principle of *lex specialis*, cited in WTO jurisprudence, which provides that where two sets of laws govern the same factual situation, the more specific law overrides the more general one.<sup>27</sup> Where one rule is a multilateral rule and the other a bilateral rule, Article 41 of the Vienna Convention further provides that two parties may modify a multilateral treaty between themselves, under certain conditions, reflecting the *lex posterior* rule.

All of these rules are grounded in the principle of the contractual freedom of states to specify and modify the rights and obligations existing between them. Although, as we have seen, the Appellate Body found that WTO rules prohibit the use of Peru's PRS for WTO members' imports, may Peru agree with particular WTO members that it may use its PRS system as regards their bilateral trade relations? Peru has done so through express agreements that are more specific and later in time with all of the major trading nations. Peru should thus normally prevail under public international law before a court of general jurisdiction if the FTA had been in effect.

The FTA provision permitting Peru's PRS, however, was clearly inconsistent with the Appellate Body's former interpretation of applicable WTO rules. The existence of such inconsistency raises a series of questions that the Appellate Body could address more clearly. First, what is the applicable law before the WTO once a WTO tribunal is seized with a WTO complaint: only the WTO "covered agreements" or the WTO agreements in light of other international law? Although WTO tribunals only have jurisdiction to hear complaints under the WTO covered agreements, there is disagreement among scholars as to whether WTO respondents may validly raise defenses under other international law before WTO tribunals.<sup>28</sup> Second, if a WTO tribunal may refer to other international law (such as another international treaty) as a defense (whether as a waiver of the right to bring a WTO claim or as a modification of the rules applicable between the parties), was there a conflict between the FTA rules and WTO rules, such that conflict-of-laws rules apply? Third, if conflict-of-laws rules apply, what was

(Contd.) \_\_\_\_\_

be eliminated entirely on the date of entry into force of this Agreement for Peru; and (ii) the specific duty derived from the application of the Peruvian Price Range System established in the D.S. N° 115-2001-EF and its amendments, any future modification or any succeeding system shall be excluded from any tariff elimination." TPP, Annex 2-D, Tariff Schedule of Peru, General Notes, paras. 4(f) and (g).

<sup>27</sup> Pauwelyn 2003, pp. 385-418. The doctrine has been recognized and applied in WTO jurisprudence regarding the relation of different WTO provisions. See Cook 2015, pp. 86-90.

<sup>28</sup> Cf. Pauwelyn 2003a (focusing more on conflicts between WTO law and other bodies of law, such as human rights law); Pauwelyn 2003b (contending that defenses under international law may be raised); Pauwelyn 2016 (critiquing the Appellate Body's decision in *Peru-Additional Duties*); Trachtman 1999 (only WTO law is applicable); Trachtman 2001; Marceau 2001 (contending that only WTO law is applicable, although other international law can affect the interpretation of WTO rules).

the parties' intent under the FTA in the event of an inconsistency or conflict with WTO rules? Fourth, if a WTO dispute settlement panel is to recognize a defense under an FTA, must the FTA itself comply with WTO requirements?

### ***A. Peru's Possible Defenses***

We commence this section with a brief overview of four primary ways Peru could raise a defense to Guatemala's WTO complaint in relation to the FTA, had the FTA been in effect, because the Appellate Body interpreted the relation of WTO rules regardless of the FTA's legal status. First, Peru could maintain that Guatemala had expressly waived its rights under the FTA to bring a WTO complaint against the PRS. Second, as a variant of the waiver defense, Peru could argue that Guatemala had expressly consented to the PRS, precluding a finding of wrongfulness under customary international law. Third, Peru could contend that, under customary rules of interpretation, WTO rules should be interpreted between FTA parties in light of the FTA. Fourth, Peru could maintain that the FTA modified WTO rules as between the FTA parties, and such modification should be recognized as a defense to the WTO complaint. Note that all these defenses serve to prevent or otherwise defend only against Guatemala bringing a WTO claim, not to justify the PRS so far as it applied to any other WTO Members.

On the first defense, the WTO Agreement has a provision on waivers (Article X), but this provision governs waivers granted by all WTO Members, not the waiver by one Member in an *inter se* agreement with another Member. The Appellate Body has recognized the ability of a Member to waive a claim in relation to a mutually agreed solution to a WTO complaint, in the *EC-Bananas 21.5* (US) case (2008). The question arises whether a WTO Member can also agree to a waiver outside of a mutually agreed solution to a specific WTO complaint. In this respect, Article 45 of the International Law Commission's Articles on Responsibility of States (ILC Articles) provides that "the responsibility of a State may not be invoked if... the injured State has validly waived the claim."

On the second defense, which is a variant of the first, Article 20 of the ILC Articles provides that "valid consent by a State to the commission of a given act by another State precludes the wrongfulness of that act in relation to the former State." Consent is "a basic international law principle" that can be raised as a defense.<sup>29</sup> It does not involve a change in substantive obligations (such as the modification of rights and obligations), but rather recognition that a state can consent to an action or measure otherwise in contravention of an international legal obligation, and that when it does, it cannot then claim responsibility from the other state. The ILC Commentary differentiates consent from a waiver in that a waiver concerns a situation where consent is given "after the conduct has occurred."<sup>30</sup> Article 20, however, would not apply if the WTO Agreement precludes the giving of bilateral consent to a WTO-inconsistent measure, and rather requires a waiver granted by all WTO Members in compliance with Article X of the WTO Agreement. Alternatively, a WTO panel might not permit such a defense if the FTA containing the consent itself is in violation of GATT requirements.

On the third defense, Article 3.2 of the WTO Dispute Settlement Understanding (DSU) provides that the WTO agreements are to be interpreted "in accordance with customary rules of interpretation of international law." Such customary rules provide means for interpreting WTO provisions, including in light of other international law. However, such other international law should be relevant to the interpretation of the WTO provisions in question, and it cannot modify their terms, but only help clarify their meaning. Moreover, such interpretations will apply to all WTO Members, and not just to the parties to a dispute.

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<sup>29</sup> ILC Articles, Article 20, Commentary, par. 1, p. 72.

<sup>30</sup> ILC Articles, Article 20 Commentary, par. 3, p. 73.

On the fourth defense, Article 41 of the Vienna Convention permits parties to modify a multilateral treaty *inter se* so long as the following conditions apply:

- (i) “the modification in question is not prohibited by the treaty”;
- (ii) the modification “does not affect the enjoyment by the other parties of their rights under the treaty”;
- (iii) the modification “does not relate to a provision, derogation from which is incompatible with the object and purpose of the treaty as a whole.”

The question is whether all of these conditions apply. The WTO treaties do not (at least expressly) prohibit *inter se* modifications. The modification arguably does not affect the *de facto* enjoyment of other WTO parties of their rights, and neither is it incompatible with the object and purpose of the WTO treaties as a whole.

Many scholars nonetheless argue that WTO panels and the Appellate Body are limited to interpreting the WTO “covered agreements,” which are *lex specialis*, so that only provisions of the WTO agreements, as interpreted in accordance with customary international law, can be used as a defense to a WTO complaint (Trachtman 1999; Trachtman 2001; Marceau 2001). These scholars cite various provisions of the DSU for support, such as DSU Article 3.2, which provides that the DSU “serves to preserve the rights and obligations of Members under the *covered agreements*,” and DSU Article 19.2, which provides that panel and Appellate Body rulings “cannot add to or diminish the rights and obligations provided in the *covered agreements*” (emphasis added).<sup>31</sup> Bartels (2001) maintains that these provisions constitute an implicit conflicts rule, and provide that WTO texts prevail in the event of a conflict.

Alternatively, however, these provisions can be viewed as statements against judicial activism in the interpretation of WTO legal texts, while saying nothing about contracting out of conventional public international law conflicts rules, especially since they contain no conflicts language within them. None of these WTO provisions, for example, is like Article 103 of the UN Charter that provides, in the event of a conflict with any other international agreement, the “obligations under the present Charter shall prevail.” Thus, other scholars stress that the WTO is an international treaty and, as such, is part of public international law (Pauwelyn 2003). They contend that, although WTO panels only have jurisdiction to hear complaints under WTO law, the WTO agreements do not provide that WTO Members have contracted out of defenses that they otherwise have under public international law, including under other treaties pursuant to Article 41 of the Vienna Convention and Article 20 of the ILC Articles.

To the extent that one accepts that other international law may apply as a defense, one must then assess whether there is a conflict between the two treaties. Some scholars maintain a narrow definition of a “conflict,” one in which a conflict occurs only if it is impossible to comply with both treaties simultaneously. Under such view of a “conflict,” obligations always prevail over permissions. Since the FTA provision is permissive and not obligatory, there would thus be no conflict. We find (with Pauwelyn, 2003) that such a narrow definition of conflict would fail to recognize the intent of the parties, and would mean that obligations always trump permissions, thereby curtailing Members’ policy space against their express agreement. As the Appellate Body itself pointed out in the

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<sup>31</sup> DSU Article 3.2 provides “The Members recognize that it serves to preserve the rights and obligations of Members under the *covered agreements*, and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law. Recommendations and rulings of the DSB cannot add to or diminish the rights and obligations provided in the *covered agreements*.” Article 19.2 again provides that “in their findings and recommendations, the panel and Appellate Body cannot add to or diminish the rights and obligations provided in the covered agreements.” DSU Article 7 further provides that “The Terms of Reference of Panels” are “To examine, in the light of the relevant provisions in (name of the *covered agreement(s)*) cited by the parties to the dispute), the matter referred to the DSB by (name of party) in document ... and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in that/those agreement(s)” (emphasis added).

Guatemala-Peru dispute, Article 4.2 of the Agreement on Agriculture provides that Peru “shall not maintain” the PRS while the FTA provides that Peru “may maintain” the PRS.<sup>32</sup>

The Peru-Guatemala FTA contains a conflict-of-laws rule, as noted above. FTA Article 1.3 provides, “[i]n the event of any inconsistency between this Treaty and the agreements referred to in paragraph 1 [such as the WTO Agreement], this Treaty shall prevail to the extent of the inconsistency, unless otherwise provided in this Treaty.” Thus, were the FTA in force, the Appellate Body, in application of Article 41 of the Vienna Convention, arguably should have recognized the parties’ express intent, unless the Appellate Body were to find that WTO Members had contracted out of customary international law and created a largely self-contained WTO regime. Had these waiver, consent, and modification defenses been raised before an international court of general jurisdiction (such as the International Court of Justice), Peru likely would have prevailed *if* the FTA were in force. But it prevailed before neither the WTO panel nor the Appellate Body, and the Appellate Body stated that its ruling would not have been altered had the FTA been in effect.<sup>33</sup>

### ***B. FTA Defenses Raised by Peru; the Panel and Appellate Body Rulings***

Peru’s failure to ratify the FTA constrained the defenses it could raise, and so Peru attempted to base its defense largely on WTO texts. Peru argued before the panel that Guatemala had failed to act in “good faith” in bringing its complaint, which violated Guatemala’s obligations under Articles 3.7 and 3.10 of the DSU.<sup>34</sup> Because the FTA was not in force, Peru cited Article 18 of the Vienna Convention which provides that “[a] State is obliged to refrain from acts which would defeat the object and purpose of a treaty” that it has signed and that is in the process of ratification. As an alternative argument, Peru maintained that the FTA had modified Guatemala’s rights under the WTO framework by maintaining that Peru could maintain its PRS, but this was a weak argument because the FTA was not in effect.

In response, the panel grounded its analysis on the fact that the FTA was not in force, and that a “treaty only begins to produce legal effects and bind the parties from the moment it enters into force.”<sup>35</sup> Since the treaty was not in effect, it created no legal obligations on Guatemala. Regarding Peru’s reference to Article 18 of the Vienna Convention, the panel responded that the question of the “defeat of the object and purpose” of a non-WTO treaty lay outside the panel’s terms of reference, which was to examine the matter brought by Guatemala “in the light of the relevant provisions of the covered agreements.”<sup>36</sup> On the issue of modification, the panel ruled: “[i]n light of this fact [that the treaty was not ratified], it is not necessary for this Panel to express an opinion on whether the parties may, through the FTA, modify between themselves their rights and obligations under the covered agreements, or whether there is a conflict of rules between the FTA and the covered agreements....”<sup>37</sup>

In its appeal, Peru expanded its defense to contend that Guatemala had waived its rights to bring a WTO complaint against Peru’s PRS after Guatemala accepted the PRS in the FTA. Peru bolstered this defense by citing Articles 20 and 45 of the ILC’s Articles on Responsibility of States. Peru, however, no longer maintained that the FTA had modified its WTO obligations, but rather contended that the

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<sup>32</sup> AB Report, para 5.94.

<sup>33</sup> AB Report, paras. 5.106, and para. 5.28.

<sup>34</sup> DSU Article 3.7, in relevant part, provides “Before bringing a case, a Member shall exercise its judgement as to whether action under these procedures would be fruitful.” DSU Article 3.10 provides, in relevant part, “It is understood that requests for conciliation and the use of the dispute settlement procedures should not be intended or considered as contentious acts and that, if a dispute arises, all Members will engage in these procedures in good faith in an effort to resolve the dispute.”

<sup>35</sup> Panel Report, Para. 7.88.

<sup>36</sup> Panel Report, para 7.92. The terms of reference are specified in DSU Article 7.

<sup>37</sup> Panel Report, Para. 7.528

WTO provisions should be interpreted in light of the FTA. The Appellate Body, since its creation, has recognized that WTO rules are to be interpreted in light of the customary rules set forth in Articles 31 and 32 of the Vienna Convention. Article 31(3) provides the following regarding a treaty's interpretation:

“There shall be taken into account, together with the context: (a) *Any subsequent agreement between the parties* regarding the interpretation of the treaty or the application of its provisions; (b) Any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) *Any relevant rules of international law applicable in the relations between the parties*” (emphasis added).

Peru maintained that the FTA was a “subsequent agreement between the parties” to the dispute, and that ILC Articles 20 and 45 were “relevant rules of international law” for the interpretation of the covered agreements.

The Appellate Body could have simply upheld the panel on the ground that the FTA had not entered into force.<sup>38</sup> Instead, the Appellate Body went beyond such reasoning to find in favor of Guatemala by stressing that its findings were “irrespective of the status of the FTA as not being ratified by both parties,”<sup>39</sup> and suggesting that modifications of trade rules through an FTA cannot be raised as a defense to a WTO complaint. As a result, the Appellate Body suggested that the WTO is largely a self-contained regime since it found that, although other international law can inform the meaning of WTO legal texts, it cannot be raised as a defense to protect Member's policy space when it conflicts with WTO obligations.<sup>40</sup>

In response to the good faith and waiver defenses, the Appellate Body found that Guatemala had “not clearly waived its right to recourse” to the DSU. Importantly, the Appellate Body did “not exclude the possibility of articulating the relinquishing of the right to initiate WTO dispute settlement proceedings in a form other than a waiver embodied in a mutually agreed solution [to a WTO dispute].”<sup>41</sup> Nonetheless, it stressed a series of conditions for it to recognize such a waiver. First, “*any such relinquishment must be made clearly*” (emphasis added).<sup>42</sup> Second, such relinquishment “should be ascertained... in relation to, or within the context of, the rules and procedures of the DSU.”<sup>43</sup> Third, the relinquishment may not go “beyond the settlement of specific disputes.”<sup>44</sup> Fourth, the Appellate Body warned that “the DSU emphasizes that ‘[a] solution mutually acceptable to the parties’ *must be* “consistent with the covered agreements” (emphasis added).<sup>45</sup>

These conditions will need to be clarified, but appear to go beyond WTO textual requirements. For example, why must a waiver apply to a specific dispute rather than a general obligation, so long as no

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<sup>38</sup> The Appellate Body noted that Peru had yet to ratify the FTA, and thus it is not clear that Peru is a “party” to the FTA, but its analysis went far beyond this fact. AB Report, para. 5.28.

<sup>39</sup> AB Report, paras. 5.106, and para. 5.28.

<sup>40</sup> A fully self-contained regime would recognize no other public international law, such as, for example, international human rights law or environmental law. However, some public international law is easier to incorporate by reference to open-ended WTO texts (such as in GATT Article XX providing for certain defenses on moral, environmental, and health grounds). The FTA provisions regarding Peru's PRS, in contrast, do not fall within the scope of GATT Article XX exceptions. See also AB Report, Mexico-Tax Measures on Soft Drinks and Other Beverages, WT/DS308/AB/R (Mar. 6, 2006), paras.56, 69-71, 78-80.

<sup>41</sup> AB Report, para. 5.25

<sup>42</sup> AB Report, para 5.25. WTO judges may be wary of interpreting FTA rules because ambiguous terms may raise difficult interpretive questions for a WTO panel, and the FTA may create its own dispute settlement system to address them, raising questions of interpretive authority. See Broude 2008 (showing how normative integration would also imply authority integration within the WTO).

<sup>43</sup> Id.

<sup>44</sup> Id., fn. 106.

<sup>45</sup> Id.

other WTO party is harmed?<sup>46</sup> Moreover, the last condition suggests that WTO Members can never waive their rights to bring a WTO complaint regarding a WTO-inconsistent provision. But what else is a waiver except permission for a party to engage in conduct that otherwise would be inconsistent with its obligations? Moreover, the provision it cites, DSU Article 3.7, only provides that a solution “consistent with the covered agreements is clearly to be preferred,” not that it is required. Parties should be able to consent among themselves to measures that the Appellate Body would otherwise find violate WTO rules, provided other WTO Members are not adversely affected, as reflected in Article 20 of the ILC Articles. The Appellate Body’s dicta is thus problematic to the extent it calls on panels to ignore parties’ clearly expressed intent.

To support its conclusion, the Appellate Body found that it was ambiguous in this case whether Guatemala consented to modify WTO rules with Peru, and thus waive its WTO rights, especially since FTA Article 1.3 confirms the FTA parties’ WTO rights.<sup>47</sup> The Appellate Body thus saw “no reason to address further Peru’s arguments that ILC Articles 20 and 45 provide additional support for its [waiver] argument,” or Peru’s arguments regarding Article 18 of the Vienna Convention.<sup>48</sup> The Appellate Body’s position, however, is counterbalanced by the fact that the FTA expressly provides that “Peru may maintain its Price Range System established in Decree no. 1152001EF,” and that the FTA contains a clear conflicts clause which provides: “*In the event of any inconsistency between this Treaty and the agreements referred to in paragraph 1 [the WTO agreements], this Treaty shall prevail to the extent of the inconsistency, unless otherwise provided in this Treaty*” (emphasis added). One could argue that the parties affirmed their desire to remain within WTO rules but believed (at the time, and Peru still believes) that the PRS complied with those rules. In such case, if it turned out that the PRS contravenes WTO rules, one could argue that it does not follow that Peru no longer needs to comply with WTO rules, but rather that the PRS must change. However, that argument seems distorting given the fact that, as between the parties, the agreement expressly states that the PRS may be maintained and that FTA rules “shall prevail” “in the event of any inconsistency” with WTO rules.

On the issue of interpretation, the Appellate Body found that WTO rules could not be interpreted to permit the PRS in light of the FTA because to do so would manifestly contradict the WTO’s text, as previously interpreted by the Appellate Body. As the Appellate Body noted, it would have to interpret the terms “shall not maintain” in Article 4.2 of the Agreement on Agriculture as “may maintain” in light of the FTA.<sup>49</sup> The Appellate Body rightly stressed that Article 31(1) of the Vienna Convention provides that the “treaty shall be interpreted” as a whole, and “not the treaty as it may apply between some of its parties.”<sup>50</sup> In sum, the Appellate Body correctly found that a WTO provision should not have different meanings for different WTO Members. Thus, to the extent that the Appellate Body is correct that Article 4.2 of the Agreement on Agriculture prohibits the use of Peru’s PRS, the language of the FTA contradicts that meaning and thus does not serve to clarify its “interpretation” under the Vienna Convention.

Although Peru focused its defense before the Appellate Body on the “interpretation” of WTO provisions, the Appellate Body rightly noted that Peru implicitly argued that the FTA had “modified” its obligations toward Guatemala.<sup>51</sup> In dicta, the Appellate Body then addressed under what conditions it would recognize such modification. It strongly suggested, “assuming arguendo that the provision of

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<sup>46</sup> It is unclear what the Appellate Body means by a specific dispute. It could refer narrowly to a WTO complaint, or it could refer broadly to a general measure that is subsequently litigated under the DSU.

<sup>47</sup> See AB Report, paras.s 5.26-5.28. See also paras. 5.110-5.111.

<sup>48</sup> AB Report, para. 5.28, fn. 109.

<sup>49</sup> Id., Para 5.94

<sup>50</sup> Id., para. 5.95. The Appellate Body also disagreed with Peru that ILC Articles 20 (regarding valid consent) and 45 (regarding valid waiver) are “relevant” rules of international law within the meaning of Article 31(3)(c) of the Vienna Convention for purposes of interpreting WTO provisions. AB Report, para. 5.104.

<sup>51</sup> AB Report, paras. 5.96-5.97.

the FTA allowed Peru to maintain a WTO-inconsistent PRS,” that Peru could not modify its WTO commitments through the FTA.<sup>52</sup> The Appellate Body noted that the WTO contains its own provisions for the amendment of WTO rules (Article X of the WTO Agreement) and for their interpretation by the membership (Article IX), as well as rules for the creation of an FTA that might be used as a defense to a WTO complaint (Article XXIV of GATT 1994).<sup>53</sup> The Appellate Body suggested that these provisions exclusively cover the modification of WTO rules, so that “we are not convinced” that Article 41 of the Vienna Convention applies.<sup>54</sup> It suggested, in other words, that WTO Members had contracted out of Article 41 of the Vienna Convention through the WTO’s own rules on amendments and exceptions.

Regarding the application of the GATT Article XXIV exception for FTAs, the Appellate Body noted two conditions for raising a defense under an FTA, citing its earlier decision in *Turkey-Textiles* (1999): (i) that the measure at issue is introduced upon formation of the FTA that meets Article XXIV requirements; and (ii) that the FTA would have been prevented were the party not permitted to introduce the measure.<sup>55</sup> Neither of these two conditions would have been met because Peru’s PRS preceded the FTA and arguably was not necessary for the FTA (although Peru certainly suggested that it was important given its refusal to ratify the agreement after Guatemala commenced the WTO dispute). Moreover, the Appellate Body stressed that the FTA exception is to facilitate trade and closer integration, and not to provide “a broad defense for measures in FTAs that roll back on Members’ rights and obligations under the WTO agreements.”<sup>56</sup>

This Appellate Body dicta again problematically refuses to recognize WTO Members’ contractual freedom to update and modify the rules that apply between them through FTAs, such as to preserve policy space for the stabilization of agricultural prices. We contend that the WTO Appellate Body was wrong in suggesting that WTO law forecloses the use of all *inter se* modifications, especially the provisions that the Appellate Body cited — Article X of the WTO Agreement and GATT Article XXIV. First, Article X of the WTO Agreement provides procedures where amendments apply to *all* WTO Members, but it does not contract out of Article 41 of the Vienna Convention regarding *inter se* modifications between WTO Members that meet Article 41’s conditions. Second, GATT Article XXIV provides an *exception* to WTO most-favored-nation (MFN) rules where a party forms an FTA or a customs union that meets specified conditions. But it does not contract away parties’ contractual freedom to modify WTO provisions *inter se* so long as the FTA meets those conditions. GATT Article XXIV is about *inter se* trade liberalization as a condition for a deviation from MFN treatment; it is not about *inter se* consent to a non-MFN related measure that does not adversely affect other WTO Members (i.e. outside the object of the GATT Article XXIV exception clause). Moreover, GATT Article XXIV is an exception to a GATT obligation, and not to the WTO Agreement on Agriculture, which was at the center of the dispute.

It seems wrong to insist that the WTO Members in 1994 foreclosed themselves from ever entering into *inter se* modifications of WTO rules that could be recognized as a defense to a WTO complaint between themselves for the rest of time, unless they agree (in practice by consensus) to amend the WTO agreements. By recognizing FTA rights, the Appellate Body would not diminish WTO rights and obligations through its interpretation. Rather, it would recognize parties’ express modifications through a political process of their WTO rights and obligations between themselves. The Appellate Body would uphold, and not diminish, the rights and obligations to which they agreed. Nonetheless, we raise an alternative response that the Appellate Body did not address in its decision: *the WTO*

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<sup>52</sup> AB Report, para. 5.111.

<sup>53</sup> AB Report, para. 5.112 and fn. 300.

<sup>54</sup> AB Report, para. 5.111.

<sup>55</sup> AB Report, para. 5.115.

<sup>56</sup> AB Report, para. 5.116.

*dispute settlement system should only recognize an FTA provision as a defense to a WTO complaint if the FTA itself complies with WTO requirements.*

### **C. What Can Be Done: Three Judicial and Three Political Options**

Given changes in global trade and Member preferences since the WTO agreements' conclusion in 1994, and given that the WTO political mechanism is blocked so that rules, interpretations, and understandings are not being updated or clarified through the WTO's political processes, it is important to find appropriate ways for WTO Members to define their trade relations through a political mechanism. This is particularly the case given complaints by some WTO members and commentators that the Appellate Body has engaged in judicial activism and "gap-filling" in interpreting WTO rules (Cartland, Depayre & Woznowski 2012). To the extent that the WTO text itself is ambiguous, as Bagwell and Sykes (2004) wrote regarding the Appellate Body's earlier *Chile-Price Band* decision), there is an even more demanding case that the Appellate Body should defer to Members that clarify, through a political mechanism, their understanding of the rules that apply between them. Even if the WTO rules are patently clear, if the WTO political process is blocked, Members should be able to negotiate the rules that apply between them outside of the WTO, as recognized under public international law.

So what can be done? There are a number of options that can be pursued, judicially and politically. Judicially, the Appellate Body can fend off the application of FTA rules or find ways to facilitate greater coherence between WTO and FTA rules. Politically, WTO Members can take different initiatives that vary in their ambition.

**1. Three Judicial Options.** A first judicial option, reflected in the Appellate Body's ruling, is to prohibit defenses under FTAs other than express waivers of the right to bring a WTO complaint. Under this scenario, WTO rules exist in parallel to FTAs, but FTA rules cannot be invoked before the WTO dispute settlement system as a defense unless there is an express waiver of a WTO right. The Appellate Body left the door ajar for a Member to expressly waive the right to bring a WTO claim through an FTA so long as the waiver is clear.<sup>57</sup> Peru thus might have prevailed had the parties added a sentence such as "Guatemala consents to the PRS and waives any rights it may have to challenge the PRS under WTO rules." But this position does not make it easy for negotiators of FTAs since it is impossible to know in advance how a measure such as the PRS will be applied, and the WTO dispute settlement system is more effective than FTA dispute settlement mechanisms. FTAs thus generally do not contain express waivers of the right to bring a WTO complaint,<sup>58</sup> even though the FTAs might be quite clear regarding the particular rights and obligations at issue, and the rules that the parties wish to prevail in the event of an inconsistency. Such a position will constrain the utility of negotiating exceptions under an FTA to enhance policy space, such as Peru's PRS.

A second judicial option would be for the Appellate Body to reverse course and apply conflict rules under international law, such as Article 41 of the Vienna Convention, since the WTO Agreement does not expressly prohibit *inter se* modifications of WTO rules, and parties should be granted the contractual freedom to update the trade rules that apply between them. The WTO Appellate Body could likewise recognize that FTA rules constitute "consent" to a measure that would otherwise violate WTO obligations, and thus preclude a finding of wrongful conduct (per Article 20 of the ILC Articles), provided (i) that the consent is sufficiently clear and (ii) that other WTO Members are not adversely affected by it.

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<sup>57</sup> See AB Report, par. 5.25

<sup>58</sup> CETA, Art. 29.3, para. 4 comes close, but only concerns dual proceedings under the FTA and WTO. It provides, "A Party may not invoke the WTO Agreement to preclude the other Party from suspending obligations pursuant to this [Dispute Settlement] Chapter."

A third judicial option, which we advance, is to permit a defense under an FTA so long as the respondent proves that the FTA meets the two core requirements under GATT Article XXIV regarding FTAs (i.e. that duties and other restrictive regulations of commerce are eliminated on “substantially all” trade among the parties, and duties and other trade restrictions are not raised against other WTO Members). The additional conditions that the Appellate Body cited from its earlier Appellate Body decision in *Turkey-Textiles* (1999) should not be relevant (such as necessity for the creation of an FTA) since those conditions come from the preamble of paragraph 5 of Article XXIV concerning the raising of a defense against a MFN-violation. Unlike Turkey, Peru was not raising new trade restrictions against a non-FTA party in violation of the MFN clause, but rather only against an FTA party, and with that party’s express consent. Under this third option, defenses could be raised under an FTA, but only provided there was no successful challenge that the FTA did not meet GATT Article XXIV’s two core requirements, namely (i) liberalization of “substantially all trade” among FTA members; and (ii) no raising of trade restrictions against other WTO Members.<sup>59</sup>

Were the FTA’s consistency with GATT Article XXIV to be addressed and the Appellate Body to find that the FTA was inconsistent with either of these two GATT Article XXIV requirements, the Appellate Body would then decline to recognize provisions of the FTA as a defense to WTO rules. This approach would help to discipline FTAs, and encourage FTA members to negotiate agreements that are consistent with GATT Article XXIV. Nonetheless, this approach runs the risk that the political and judicial stresses of actually verifying the consistency of FTAs with GATT Article XXIV – a task that the GATT and the WTO have studiously avoided – would worsen the current political stalemate in the WTO. There is also the possible danger that FTAs have become so strongly the locus of trade-policy making that the WTO and its multilateral system of surveillance become irrelevant.

2. Three Political Options. If the Appellate Body’s dicta in *Peru-Additional Duty* effectively eliminates the ability of WTO Members to raise FTA defenses, then WTO Members can turn to political options that range in their ambition. First, in complement with the first judicial option, individual WTO Members could write into their FTAs clear and express waivers of their rights to bring a WTO complaint in relation to specific measures (such as Peru’s PRS). The Appellate Body already has recognized that it must interpret other international treaties, whether in the context of waivers, interpreting WTO obligations, or interpreting WTO provisions that incorporate other international treaties (Palmer & Mavroidis 1998; Pauwelyn 2016). Yet, this option could be of limited value, largely because the FTA dispute settlement mechanisms do not provide the certainty and predictability that the WTO provides so that Members will be wary of waiving their right to bring a WTO complaint.

Second, if the Appellate Body does not change its position, a more ambitious solution would be for the WTO membership to create a protocol confirming that WTO panels and the WTO Appellate Body are authorized to raise FTA provisions as defenses to WTO claims, so long as the defense does not prejudice the rights or obligations of any WTO Member that is not a party to the FTA. Such confirmation would be a signal to the Appellate Body that WTO provisions for amendments of the WTO agreements (applying to all WTO Members) do not supersede Article 41 of the Vienna Convention concerning *inter se* modifications of rights and obligations as a defense to a WTO complaint.

Third, a much more ambitious approach would be to transform the WTO dispute settlement system into a system of general jurisdiction for all trade agreements that contain a compromissory clause recognizing its jurisdiction, and that provide adequate funding to support any necessary expansion of the WTO secretariat, panels, and Appellate Body (Trebilcock 2015; Flett 2015). The WTO already hires additional secretariat members for particular cases (the Boeing-Airbus case being a notorious

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<sup>59</sup> See GATT Article XXIV, paras. 5 and 8.

example) and panelists are funded on an ad hoc basis. Such adaptation is easily conceivable, although the membership of the Appellate Body may need to be expanded slightly.

Under this scenario, the WTO dispute settlement system would be able to hear complaints, as well as defenses, under FTAs. New issues would of course arise based on the FTA's updating and clarification of trade rules. That is not a problem, however, because it is what the WTO as a negotiating forum was supposed to do. Since the Doha Round of trade negotiations has collapsed, and since the political process for updating and clarifying rules has migrated to FTAs, this approach contends that the WTO dispute settlement mechanism should be adapted. Otherwise the WTO judicial process and the FTA political process will be in tension, imbalanced, and incoherent. Over time, the last bastions of WTO relevance — WTO monitoring bodies and dispute settlement — could slowly die. Such a more pluralist approach to trade negotiations, moreover, could have the advantage that it facilitates the ability of sovereign countries to tailor rules to their differing contexts in a diverse world. The WTO institution would, under this scenario, remain critical in keeping FTAs under multilateral surveillance so as to ensure greater trust and potentially facilitate their inclusivity over time, possibly leading to the amendment of WTO rules for the entire membership.

It is unlikely that WTO Members can reach agreement over either of the last two political options, given the difficulty of reaching consensus among over 160 WTO Members. Thus, pressure will increase on the Appellate Body to interpret WTO rules for today's changed landscape, and to find ways to accept defenses under WTO-consistent FTAs. As trade agreements proliferate and possibly extend to mega-regionals such as the TPP, the WTO needs to stay relevant. One way is by contributing to the systemic integration of politically negotiated trade outcomes through the WTO judicial mechanism. In its very first case, *US-Reformulated Gasoline* (1996, p. 17), the Appellate Body wrote that WTO rules should not be read "in clinical isolation from public international law." The WTO Appellate Body has integrated public international law concerns over the environment and public health through its interpretation of the open-ended language of GATT Article XX. The new challenge for the Appellate Body is how to address the sprawling world of FTAs in WTO jurisprudence.

## **Conclusion**

*Peru-Additional Duty* raises the question of how a WTO dispute settlement panel and the Appellate Body should respond when a party accepts a measure in an FTA and then brings a complaint that the measure violates WTO rules. It is not an isolated issue. Studies show that significant numbers of FTAs contain provisions that appear to cut back on WTO liberalization requirements as applied among FTA Members, such as regarding export restrictions (Zhang 2016).

Peru bound its tariffs for the four categories of agricultural products in question at 68%. It then lowered its applied tariff rate to 0%, but subject to a Price Range System where tariffs can increase on a fortnightly basis (although no more than the binding) if the international market price is less than the monthly average price over the previous five years. In parallel, Peru signed a series of FTAs where the contracting parties arguably consent to its use of the PRS, signaling that Peru wishes to contract out of WTO rules to the extent that the PRS violates them.

Peru's PRS seeks to stabilize agricultural prices in Peru and offer a degree of protection to Peruvian producers. We show that the Peruvian PRS is less restrictive than the classic variable levy used by the E.U., which was the object of contention during the Uruguay Round, but it still shares many of its features. Given the evolution of world prices since the PRS was instituted in 2001, the PRS has turned out to have a rather slight stabilizing effect and a more significant protective effect, although it remains much less protectionist than Peru's tariff binding.

WTO rules, and in particular Article 4.2 of the Agreement on Agriculture, prohibit the use of variable import levies. The Appellate Body, following its earlier jurisprudence in *Chile-Price Band*,

held that the PRS was effectively a variable import levy and likely a minimum import price in violation of Article 4.2 of the WTO Agreement on Agriculture.

A critical question, however, remained: whether the Peru-Guatemala FTA, which provides that Peru “may maintain” the PRS, could be used as a defense to the WTO complaint from Guatemala. The panel avoided the issue by noting that Peru had not ratified the FTA. The Appellate Body, in contrast, went beyond this reasoning and suggested that FTA rules cannot be used as a defense. Such a suggestion has significant systemic implications, especially given global political developments and the proliferation of FTAs. It might appear presumptuous for a WTO tribunal to find that WTO rules forever trump FTA rules regarding Members’ policy space, even when the FTA complies with WTO requirements, and the FTA rules are later in time, directly on point, respond to dissatisfaction with an earlier Appellate Body ruling, do not adversely affect other WTO Members, and public international law provides rules that enable a panel to avoid an outcome that would violate the parties’ contractual freedom and their clear intent.

We presented a number of judicial and political alternative courses of action to address this situation. These alternatives include permitting clear consents or waivers as a defense, permitting the use of FTA provisions as a defense if there is a conflict with a WTO rule provided the FTA complies with GATT Article XXIV’s requirements, and fully incorporating FTA rules into the WTO dispute settlement system. Where FTAs are not consistent with GATT Article XXIV’s requirements, there is a good argument not to recognize FTA provisions as a defense to an otherwise valid WTO complaint. However, if the Appellate Body does not recognize provisions in valid FTAs as defenses, the WTO judicial process will fail to take into account Member’s agreements regarding the rules that apply between them. The WTO would risk becoming irrelevant since FTAs are where trade policy is currently being formulated. Irrelevance would be costly since the WTO provides critical global services, including inclusive, non-discriminatory, multilateral rules, multilateral surveillance, and dispute settlement. An ongoing challenge for the WTO and its Members is how the WTO dispute settlement system engages with FTAs. The saga continues.

## **Appendix:**

### ***A. The Uruguay Round Negotiations on Agriculture.***

The frictions over agriculture between the U.S. and the E.U. are well documented (Josling and Tangermann, 2015). Disputes about domestic support and export subsidies were the most contentious, but the highly constrained access to the E.U. market was also a major sore: it affected some U.S. exporters directly and it was an indispensable prop to the domestic support system, which raised internal prices and thus boosted E.U. output. The Kennedy Round of negotiations (1973-77) failed to address these frictions and they grew worse over the subsequent years. The GATT Ministerial of 1982 established a Committee on Trade in Agriculture, although the latter’s deliberations served mostly to highlight the differences between the U.S. and the E.U. With pressure to start a new trade round to help spur international growth, an apparent compromise was reached in the Punta del Este Declaration of 1986 (GATT, 1986) that initiated the Uruguay Round. It stated, *inter alia*,

Negotiations shall aim to achieve greater liberalization of trade in agriculture and bring all measures affecting import access and export competition under strengthened and more operationally effective GATT rules and disciplines [and reduce] ... import barriers;

The U.S.’s opening position was that this required the abolition of all trade distorting subsidies (including market access restrictions) over ten years – the so-called ‘zero-option’. The mid-term review in Montreal, December 1988 collapsed over agriculture, but the so-called Geneva Accord in early 1989 revived talks and called for position papers by December of that year. The U.S.’s paper called for the prohibition of all import barriers not explicitly permitted by the GATT; the approach

called for the conversion of all import barriers into tariffs – so-called tariffication – and then to reduce these tariffs gradually to zero through negotiations.<sup>60</sup> The E.U. conceded the principle of reform but offered little in practice. The supposedly ‘final’ Ministerial Meeting in Brussels in December 1990 collapsed, largely on the rocks of agriculture, but talks resumed early in 1991. In a series of high-level meetings, each side slowly conceded ground – constrained in part by domestic political pressures – and in December 1991, Director-General Dunkel felt ready to issue a draft text, which he hoped would be completed by April 1992. This goal proved impossible and the high-level bilateral and plurilateral negotiations continued throughout 1992, given added focus by a U.S. threat to impose sanctions in an ongoing dispute with the E.U. about oilseeds.

U.S. and E.U. negotiators met at Blair House in Washington DC in November 1992 and apparently settled their remaining differences, but in fact neither the U.S. nor the E.U. could get full internal agreement to it and the negotiations dragged on until December 1993. The new Director-General of the GATT, Peter Sutherland, had set a drop-dead date of 15<sup>th</sup> December for completion. As Croome (1999, p. 316) notes, it was obvious that the Round would close only when agreement was reached between the U.S. and the E.U. While agricultural market access was not the only contentious issue, it was arguably the most critical. Other countries made offers and expressed positions, but they argued that everything was conditional on the ultimate U.S.-E.U. agreement. The two sides reached agreement on agriculture on the 9<sup>th</sup> December, but other issues, including an exception for Japan on its rice market, kept negotiations rolling until 7:30pm on the 15<sup>th</sup> December, at which point The Draft Final Act of the Uruguay Round was presented and approved.<sup>61</sup>

The Final Act encompassed the Agreement on Agriculture, Article 4.2 of which prohibited “...measures of the kind which have been required to be converted into ordinary customs duties...” with its ostensibly clarificatory footnote that these “included ... variable import levies, minimum import prices, ... and similar border measures...” This provision lies at the heart of the *Chile-Price Band* and *Peru-Additional Duty* disputes that we discuss below.

The history of the Round offers one last powerful insight into what negotiators intended or expected. Agreement on the Final Act left a huge amount of technical detail to be completed before its signature by April 1994, including the preparation of countries’ final schedules of concessions. The key element of the latter was the so-called ‘Modalities’ published on 20<sup>th</sup> December 1993 (MTN.GNG/MA/W/24), which specified how the schedules were to be completed. Annex III, Section A, paragraph 1, of the Modalities states:

“The policy coverage of tariffication shall include *all* border measures other than ordinary customs duties *such as*: quantitative import restrictions, variable import levies, minimum import prices, ... and any other schemes similar to those listed above, whether or not the measures are maintained under country-specific derogations from the provisions of the GATT 1947.” (Emphasis added)

Although the Modalities provide that they “shall not be used as a basis for dispute settlement proceedings” (p. 1), the text makes clear the expectation that everything other than “ordinary customs duties” was liable to tariffication.

Also important for our purposes is the timetable, which stipulated that “The [Uruguay Round] Protocol itself will be opened for signature at the Special Ministerial Session Schedule for 12 to 15 April 1994,” and that

“In order to meet this time limit each participant is required to submit its draft final Schedule to the Secretariat for circulation to all participants not later than 15 February 1994. There will then be

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<sup>60</sup> GATT, MTN.GNG/NG5/W/97.

<sup>61</sup> Domestic pressures in the E.U. contributed to its willingness to settle on agriculture – e.g. the cost of support and the prospect of enlargement – but they did not require the abolition of variable levies. The latter, in our view, was largely due to the Round.

a period for verification of the draft final Schedules until 31 March 1994 to ensure that the results negotiated and agreed are accurately reflected in the Schedules.”

The run up to the 15<sup>th</sup> December 1993 had been a ‘phoney war’ for most participants most of the time. Although positions had been stated and bilateral negotiations undertaken, they were always overshadowed by the possibility (often, apparent likelihood) that they would be rendered moot by E.U.-U.S. agreement or lack of it. Moreover, while Hatherway and Ingco (1996, p. 38) state that the modalities were often over-ridden by bilateral negotiations of a request and offer nature in the first few weeks of 1994, it is unrealistic to believe that this was a considered, thorough negotiation. The timetable was extremely tight and all members had been worn down by the constant uncertainty of a seven-year dispute between the two trading giants. To have challenged another party’s Schedule after submission and thus to endanger the delicate balance that had been achieved to complete the Round was just about unthinkable.<sup>62</sup> Thus one cannot plausibly argue that because Peru’s PRS (in its earlier guise) was not challenged in the Round, it had been accepted by WTO Members.<sup>63</sup>

The protracted negotiation and the domestic pressures on the U.S. and E.U. negotiators stripped the Round of most of its liberalising effect in agriculture. Even without dirty tariffication, the base for tariffication was set as 1986-88, a period of very low world prices and hence high protective effect for non-tariff barriers. Many developing countries had unbound tariffs at the start of the Round and so were able to schedule ‘ceiling bindings’ (bindings unrelated to any objective indicator at all), rather than tariffication. Tariff reductions from the base levels were to have a simple average of 36% with a minimum of 15%, so that high tariffs needed only be reduced by the 15% minimum. Several countries received extended time periods for reductions. Moreover, the reductions in export subsidies and domestic support were mild, at least relative to hopes at the beginning of the Round.

Thus, as early as 1995, commentators claimed that the Round’s main achievement in agriculture was not that agricultural trade barriers had actually been reduced but that the system had been rationalised and that through tariffication the means to future liberalisation had been secured. Hathaway and Ingco (1995) write: “The promise of the Uruguay Round agreement really lies in the future it makes possible. The groundwork has been laid for serious trade liberalization in the next round of negotiations.” If this is what WTO Members got from seven years’ hard politicking, it is easy to see why trade officials, especially those from agricultural exporting nations, became so wedded to the principle of tariffication and the elimination of variable levy and minimum import price schemes. Of the six third party statements reported in Annex C to the Panel report of *Peru-Additional Duty*, the three from large agricultural exporters – Argentina, Brazil and the U.S. – not surprisingly insist that Peru’s PRS was not consistent with WTO rules.<sup>64</sup>

## ***B. The data***

The ceiling and floor prices are drawn from six-monthly Supreme Decrees No. 115-2001-EF (21/June 2001) to 164-2013- EF (29/June/2013). The reference price data are drawn from the fortnightly Resolución Ministerial, from No.225-2001-EF/15 (10/July/2001) to No.020-2013-EF/15.01 (4/October/2013). The full list of sources is reported in the Panel Report 457R pp. 52-59.

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<sup>62</sup> This point was as true for the U.S. and the E.U. as the others: each was aware of how its own and the other’s domestic politics could intervene and undermine the agreement.

<sup>63</sup> Additional evidence of the lack of scrutiny of the Schedules comes from the emergence of so-called ‘dirty tariffication’ – Ingco (1995). Ingco shows that many of the bindings that were entered into the schedules did not strictly apply the modalities and that deviations almost universally resulted in higher protection than the already high levels that they permitted.

<sup>64</sup> WT/DS457/R Addendum, Annex C.

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