

The Reform of the WTO's Appellate Body: An Economic Perspective

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I. Introduction

The United States under the Trump administration blocked the appointment of new members to the Appellate Body (“AB”) of the World Trade Organization (“WTO”) since 2017. As the terms of incumbent AB members sequentially ended, the number of members required for appellate review fell short of the quorum. Consequently, the AB has been rendered non-functional from December 2019.

As the impasse over the reappointment of new AB members occurred amidst incessant conflicts between the US and its major trading partners, some may have expected that President Biden would attempt to resolve the WTO AB’s deadlock. Indeed, the Biden administration emphasized multilateral approaches to international affairs from the beginning of taking office. However, it turns out that the new US administration will hold on to the same view on the WTO AB crisis as its predecessor, confirming that the WTO AB will remain par-

alyzed until the US’s long-standing and bipartisan concerns about the AB’s functioning are resolved.

A 2020 USTR report on the AB explicitly raises these concerns, making it helpful to understand the views of the US and find feasible paths to reforming the AB. As shown in Table 1, the USTR report claims that the AB violates the WTO rules with respect to dispute settlement and jurisprudence and makes errors in interpreting WTO agreements.

Table 1. Issues related to WTO AB raised by USTR (2020)

I. AB violates the rules imposed by WTO members
Disregarded the mandatory 90-day deadline for issuing a report
Allowed former members to decide cases after their terms have ended
Reviewed panel findings of fact, including the meaning of WTO members’ domestic law
Rendered advisory opinions on issues not necessary to resolve a dispute

Claimed that reports are entitled to be treated as binding precedent and must be followed by panels without “co-gent reasons”
Failed to make the recommendation required when a measure has expired after panel establishment
Opined on matters within the authority of other WTO Bodies
Deemed decisions not made under the procedures within WTO Agreement to be “authoritative interpretations of covered agreements”
II. AB errors in interpreting WTO agreements
Interpretation of “Public Body” as to SOEs
Interpretation of the non-discrimination obligation under the TBT agreement and the GATT 1994
Prohibition on the use of “zeroing”
Stringent test for using out-of-country benchmarks
Non-text-based interpretation of Article XIX of the GATT 1994 and the Safeguards Agreement
Interpretation of the Subsidies Agreement as to Non-Market Economies

Source: Author’s summarization based on USTR (2020).

Instead of thoroughly reviewing the respective issues, I focus on two main criticisms leveled by the US against rulings of the WTO AB – namely, the WTO AB’s activist role in interpreting WTO agreements, and the standard applied when reviewing issues of the respondent’s domestic law. There are two reasons to rule out other issues in this study. First, the AB’s interpretation of WTO agreements and standard of review as to domestic law are closely related to the issues of alleged “judicial activism” which is criticized by the US. The US has called into question AB’s overreach in its ruling on a recurring basis while other WTO members have infrequently expressed their concerns. Second, in the discussion of AB reform, procedural improvements

of the WTO Dispute Settlement Process (“DSP”) have been a subject of relatively long-standing debate while recent discussions reflect the AB’s interpretation and reviews.

In this study, I build a game-theoretical model to analyze the impact of AB reform on WTO members’ trade policies and strategic use of DSP. Specifically, I extend Maggi and Staiger (2011), which relates the accuracy of the Dispute Settlement Body’s rulings to the member countries’ trade policies, by allowing the WTO AB to make a strategic decision maximizing the number of proper rulings based on a noisy signal being correlated with the trading countries’ joint payoffs. Consistent with Maggi and Staiger (2011), I find that member countries are more likely to file an appeal to the AB when its interpretation of ambiguous WTO agreements gives rise to uncertainty about AB rulings. However, unlike Maggi and Staiger (2011), this study pins down the informational conditions under which such results arise. With this feature, I argue that activist rulings by the AB should be always uncertain without respect to the realized state in order for the disputing parties to appeal to the AB in equilibrium. Another departure from Maggi and Staiger (2011) is in the area of AB reviews of a respondent’s domestic law. If the AB’s reviewing domestic law significantly affects the defending country’s payoffs, then in equilibrium, appealing to the AB never arises. In the following, I explain the model used to describe the AB’s legal proceedings and member countries’ decisions on trade policy and litigation. Also, I provide several theoretical results that speak to the reform of the WTO AB.

II. Model and Main Results

Setting

In the model, there are two countries, called “home country” and “foreign country.” For simplicity, it is assumed that there is one industry where home country imports foreign country’s goods. At the beginning of the game, a random variable, which is related to the true state representing damages incurred to the home country’s domestic industry, is determined. The state random variables can have either of two values, say, high (H) and low (L) values. When the realized value is H, this implies that the domestic industry’s damages are so high that a protectionism policy is recommended for the home country to maximize the joint payoff of the two countries. On the other hand, if the realized value is L, this implies that a free trade policy by the home country is recommended because the damages to the home country’s domestic industry are bearable. I assume that both countries can observe the realized value while the WTO’s Dispute Settlement Body (“DSB”) cannot. This assumption describes the information asymmetry arising between disputing countries and the DSB.

After observing the realized value of the random variable, home country decides a trade policy choosing between “protectionism” and “free trade.” Home country prefers “protectionism” to “free trade,” but in contrast, foreign country prefers “free trade” to “protectionism.”

After home country’s decision on its trade policy is made, foreign country decides whether to initiate DSP. If foreign country allows home country’s policy and does not initiate DSP, the game ends. Otherwise, the DSP is initiated and disputing countries incur litigation costs in the first Panel stage. After the Panel’s ruling is made, if a losing country settles, the game ends. If not, then the losing country can appeal to the AB. As in the Panel stage, both countries incur litigation costs again in the AB stage. After the AB’s ruling, both countries accept the ruling and the game ends.¹

AB’s interpretation of WTO rules

To explain how the model accommodates the issues of the AB’s interpretation of WTO rules, it is necessary to clarify how this study perceives the WTO rules and the WTO legal system’s role.

In this study, the WTO rules are considered as a contract that is agreed upon among multiple countries. Due to the costs arising from bargaining and drafting on specific terms, however, the contract is regarded as being intrinsically incomplete. For example, in the WTO rules on subsidies and countervailing measures, a subsidy is “deemed to exist if: (a) (1) there is a financial contribution by a government or any public body within the territory of a Member...” The agreement contains the term “public body” to qualify the benefactors which are banned from providing harmful subsidies

¹ Please refer to the appendix for a more detailed explanation on the timing of game.

while it does not specifically entail the list of entities which are considered to be a “public body.” Such ambiguity or “gap” in the text is unavoidable because at the time of negotiations over the WTO rules it was impossible for member countries to make contingencies on every future outcome, let alone aligning their political interests.

The incompleteness of the WTO rules plays a key role in modelling the DSP because hypothetically complete WTO rules can eliminate a potential dispute between countries.² If a country is perceived to certainly violate the WTO rules and becomes the subject of complaint at the WTO regarding its trade policy, the country would rationally expect that the WTO dispute settlement body resolves the issue according to a specific rule precisely and the country would be obliged to redress its decision after all. Thus, it is rational for the country not to engage in DSP, incurring litigation costs only to lose in the legal proceedings and rather not to take deviating actions from the WTO rules in the first place.

Given that the WTO rules have some ambiguity or gap in the legal text, this study assumes that the Panel and AB are different in how they interpret the rules. Specifically, the AB actively interprets the WTO rules while the Panel does not. When the AB actively interprets the WTO rules, the ambiguity or gap

in the text in question would be cleared by the AB’s rulings as it attempts to maximize the joint payoff of the two conflicting countries. On the other hand, the Panel does not actively interpret the WTO rules, and thus, its rulings do not add or diminish the rights and obligations of member countries. This implies that it is very unlikely for the Panel to authorize retaliatory measures against the defending member without its explicit violation of law. If the AB was also assumed to behave like the Panel in interpreting WTO rules, the AB would never be invoked in the DSP because the losing country in the Panel stage expects an AB decision would be identical to the Panel’s. In this regard, whether the AB actively interprets the WTO rules changes strategic behaviors of disputing members and related outcomes.

Interestingly, in the case where the AB actively interprets the WTO rules, if disputing countries can perfectly predict the AB’s rulings, both would not go to the AB. This is simply because if they knew the predetermined outcome, they may not want to incur litigation costs anymore by appealing to the AB. Instead, they settle after the Panel’s decision. To sum up, what matters in AB’s activism is the uncertainty arising from how it interprets the rules, not activism *per se*, and due to the very uncertainty the losing party in the Panel stage appeals to the AB.

² Strict enforcement of rules is also necessary for countries to comply with WTO rules. In this study, I assume that AB’s rulings are fully implemented once they are made.

As aforementioned above, I assume that there are two underlying states, described by a random variable, under which a home country's protectionism policy is good or bad, respectively. I characterize the activist AB's preferences as matching its ruling with the true state to maximize the member countries' joint payoff. Specifically, to give a "right ruling," AB should recommend "free trade" when "L" state is realized, while recommending "protectionism" when "H" state is realized. However, AB cannot observe the true state, so it is assumed that it only infers the true state after receiving a random signal that is correlated with the true state. AB's receiving an informative signal which relates to a true state means that the uncertain aspect of AB's ruling comes out of AB's ability to infer the true state.

In my framework, since AB is described as a strategic Bayesian player which tries to match the true state by gathering all relevant information, strategic moves made by disputing countries can also affect the AB's inference on the true state. Loosely speaking, the AB in this model interprets the WTO rules with more activist intent than Maggi and Staiger (2011)'s DSB, whose activist characteristic is mechanically and non-strategically described.

When a state is realized, in my model, whether AB is invoked in equilibrium depends on the overall benefit from initiating DSP for a party whose preferable outcome is adverse to the realized state. Specifically, in "H" state, the foreign country's expected gains from initiating DSP matter while in "L" state, the home country's expected gains matter. These

gains should be large enough for guaranteeing the existence of equilibrium outcomes where AB is invoked. This implies that in such equilibria AB's rulings are uncertain enough in each state. If either condition is not satisfied, AB can perfectly infer the true state by observing the moves of disputing parties. This does not give much qualitative difference from Maggi and Staiger (2011)'s result in that AB is invoked when AB's rulings are uncertain enough. However, this study imposes an additional condition that AB's rulings should be symmetrically uncertain for the disputing parties regardless of the realized state.

Banning the AB's activist role in any case would result in a lower number of litigations through the DSP, which may save litigation costs, but with many opportunistic policy decisions made by home country. Moreover, it could eliminate a desirable equilibrium outcome in which home country abstains from implementing protectionism policy in "L" state to avoid complaint via the DSP when the AB is highly capable of matching the true state and its rulings attain the first-best outcome.

Standard of review as to domestic law

Reviewing facts including the meaning of WTO members' domestic law by the AB burdens the defending country when it loses in proceedings for the issues regarding its domestic law. This may force the country to amend its domestic law in order to comply with the WTO rules, but may also decrease available policy instruments which will be used for protecting the domestic industry from

unfair trade practices. Thus, restricting the range of policy instruments resulting from losing at the appellate stage adds an extra cost to home country while it additionally benefits foreign country in future trade relations.

My model simply captures such an externality, which arises from the AB's reviewing the meaning of domestic law, by changing payoffs of both countries when the AB rules "free trade." In other words, a certain amount of payoff, say, K , is deducted from home country's payoff and is added to foreign country's payoff when the AB reviews the meaning of domestic law and the home country loses.

My analysis shows that when AB reviews the meaning of member country's domestic law, this may play as punitive damages imposed on home country's violation of the WTO rules. In this case, in "L" state it is always profitable for foreign country to go to the AB regardless of its ability to infer the true state once home country chooses "protectionism." Expecting that, home country always chooses "free trade" in "L" state to avoid DSP. Given this, in "H" state home country chooses "protectionism" if and only if AB infers the true state precisely. When AB infers the true state precisely, there exists an efficient equilibrium where home country chooses the first best policy without involving DSP. However, if AB matches the true state poorly in "H" state, home country never chooses "protectionism" in fear of the AB's ruling. As a result, "free trade" policy is excessively chosen by home country beyond an efficient level.

The above results hold only when the size of the externality coming from AB's reviewing domestic law is significant, and more interestingly, in these cases AB is invoked off-the-equilibrium path. So, if the AB is invoked in disputes cases, this may imply that the externality is negligible; thereby limiting the AB's standard of review does not much qualitatively change the strategic decisions of disputing countries. Otherwise, banning the AB's review on defending country's domestic law may eliminate an excessive "free trade" policy bias, but also eliminate efficient first-best outcomes that could be chosen by home country.

III. Conclusion

Throughout this study, I consider some possible changes that may occur when the WTO's AB is reformed based on the opinions stated by the US. Especially focusing on the issues of activist AB and its reviewing member countries' domestic law, I conclude that banning the AB's activist role may result in more opportunistic and inefficient policy choices on the part of member countries as to importing industries with less disputes cases. Regarding the latter issue, I argue that limiting the AB's standard of review does not much change strategic decisions of member countries.

The crisis of multilateralism arising from rising protectionism and unilateral trade measures deepens in the era of COVID-19. Governments jump into the action of securing personal protective equipment and COVID-19 vaccines by imposing exports restrictions. A global rise of nationalism ramps up tensions between racial and ethnic

groups in many countries. These ominously point to the even worse dismantling of the global trading system in the post-COVID-19 era. Before it proves too late, it is imperative for WTO member countries participating in the WTO's 12th Ministerial Conference to break the deadlock of the AB to restore confidence in the rule-based multilateral trading system. **KIEP**

References

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Appendix – Timing of Game

1. A state variable s , describing the events that occur in the domestic industry of home country, is randomly drawn from an uniform distribution defined on $[0,1]$, and is revealed to all players including home country(H), foreign country(F), and DSB.
2. A state variable $\theta \in \{\theta_H, \theta_L\}$, which is relevant to the joint payoff of home country and foreign country, is realized and observed to both countries. The probability of $\theta = \theta_H$ is equal to q , and the probability of $\theta = \theta_L$ is equal to $(1 - q)$.
3. H chooses a trade policy $\tau \in \{P, T\}$. If $\tau = T$ (Free trade), the game ends and H and F get $r_H^T(\theta)$ and $r_F^T(\theta)$, respectively.
4. If $\tau = P$ (Protectionism), F decides whether to go to the Panel of the WTO DSB. If F decides not to go to Panel, the game ends and H and F get $r_H^P(\theta)$ and $r_F^P(\theta)$, respectively. If F decides to go to the Panel, H and F pay c_H and c_F , respectively, and move to the next stage.
5. Panel rules according to the following decision rule, denoted by a function d_{panel} :

$$d_{panel}(s) = \begin{cases} T & \text{if } 0 \leq s < s(\theta_H) \\ P & \text{if } s(\theta_H) \leq s \leq 1 \end{cases}$$

where the sum of both countries' payoffs are indifferent between T and P at $(\theta_H, s(\theta_H))$.

6. In the previous stage, if $d_{panel}(s) = P$, then F can decide to either appeal to AB or settle for the result. For the former case, H and F pay c_H and c_F , respectively, and move to the next stage. For the latter case, the game ends and H and F get $r_H^P(\theta)$ and $r_F^P(\theta)$, respectively. If $d_{panel}(s) = T$, then H can decide either appealing to AB or settling to the result. For the former case, H and F pay c_H and c_F , respectively, and move to the next stage. For the latter case, the game ends and H and F get $r_H^T(\theta)$ and $r_F^T(\theta)$, respectively.
7. If $\theta = \theta_H$, AB receives a signal, say, y_H , with probability $\alpha(\geq 0.5)$ and receives a signal, say, y_L , with probability $(1 - \alpha)$. If $\theta = \theta_L$, AB receives a signal, say, y_L , with probability $\beta(\geq 0.5)$ and receives a signal, say, y_H , with probability $(1 - \beta)$.
8. AB updates its belief, $\mu_i = \Pr(\theta = \theta_H | y_i, \sigma_H, \sigma_F)$, based on the received signal, y_i ($i \in \{H, L\}$), the strategy of H, σ_H , and the strategy of F, σ_F , and rules according to the following decision rule, denoted by a function d_{AB} :

$$d_{AB}(s, \mu_i) = \begin{cases} T & \text{if } 0 \leq s < s(\theta_H) \\ A_i & \text{if } s(\theta_H) \leq s < s(\theta_L), \text{ where } A_i = \begin{cases} T & \text{if } 0 \leq \mu_i < 0.5 \\ P & \text{if } 0.5 \leq \mu_i \leq 1 \end{cases} \\ P & \text{if } s(\theta_L) \leq s \leq 1 \end{cases}$$

and the sum of both countries' payoffs are indifferent between T and P at $(\theta_L, s(\theta_L))$.