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Loopholes, Legal Interpretations and Game Playing: Whither the WTO without the *Spirit of the GATT*?

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Abstract

As with any document with legal form, the GATT and WTO agreements are replete with loopholes, vagueness and procedural rigidities that can be used to thwart or diminish the efficacy of what was intended when the document was agreed and drafted. Exploitation of such weaknesses is expected in, for example, tax codes. Until recently, the member states of the WTO have largely refrained from taking advantage of the opportunities for circumvention presented in the legal documents. The reason lies in the conduct embodied in the Spirit of the GATT which was informally embraced by member states and their diplomats right from the inception of the GATT. In recent years, however, acceptance of the Spirit of the GATT has waned, leading to exploitation of loopholes and other weaknesses of the WTO architecture, which threatens the ability of the organization and its agreements to function as intended. This paper examines two loopholes – (1) the Article XX(a) public morals exemptions and (2) the Article XXI national security exemption – and looks at how their recent use threatens the future viability of the WTO.

Keywords: loopholes, national security, public morals, spirit of the GATT

Introduction

> [For] essential security interests … the spirit in which Members of the Organization would interpret these provisions was the only guarantee against abuse.
>
> Discussion in: The Contracting Parties to the General Agreement on Tariffs and Trade (1953)

> When the GATT organization was first started there was considerable distrust of lawyers, for it was felt that GATT was a club inhabited by diplomats of impeccable reputation who would ensure that its affairs would be conducted with all seemly propriety. Should any unhappy differences arise they would be settled privately according to the feeling of the general consensus. … and this, together with the concept that the better solutions were to be found in the economic rather than the legalistic field, resulted in a preference for conciliation on the basis of an agreed compromise rather than a decision on a legal basis.
>
> D. Thomson (1981)

Any formal system of laws or regulations will have loopholes that can be exploited, areas where strict interpretations that do not reflect the intent of the drafters can be used to advantage and structures and procedures that can be gamed to lessen the efficacy of its administration. In the case of the World Trade Organization (WTO), and the General Agreement on Tariffs and Trade (GATT) that provided its intellectual and operational foundation, the rules were purposely left vague so that there was room for compromise (Hudec, 1980; Kerr, 2018a). As a result, there exist, and have always existed, the means by which countries could escape the agreements' disciplines and impair the functioning of the organization. According to Hahn (1991, 559),

> … the broadly tailored exceptions of article XX, and article XXI … strikes the reader as coming rather close to granting *carte blanche* to the Contracting Parties of the "constitution of world trade" to strip off any legal bonds imposed on them – leaving them to apply the rules as they wish.

Until recently, by and large, countries have not availed themselves of such avenues.

The *Spirit of the GATT*

The reason countries used restraint in their interactions with the GATT/WTO lie in what is commonly referred to as the *Spirit of the GATT* (Hahn, 1991; Jackson, 1978;

Weinrichter, 1999; Nichols, 1996; Thurow, 1999). While there are numerous references to the *Spirit of the GATT* in the literature, a succinct definition is elusive.[1] There are two facets to how member states of the WTO deal with the rules of trade following the *Spirit of the GATT*. First, countries treat the agreed rules of trade as ones which will promote economic betterment and prosperity through liberalization. In general, trade liberalization through international cooperation is expected to be welfare enhancing (Jackson, 1989). While the agreed rules of trade constrain the activities of individual member states, the constraints are accepted in the name of reaping the benefits of trade.

Second, restraint will be the rule for the use of exceptions, loopholes, escape clauses and safeguard clauses (Finlayson and Zacher, 1981). According to Jackson (1989, 207) when referring to exceptions in the GATT, "Obviously, clever argumentation could be used to justify practices which have as their secret goal preventing import competition." The exceptions are written to be just that, exceptions that are not just theoretical, but in fact, can be used by member states without international oversight. Their wholesale use would threaten the efficacy of the agreed rules of trade and the WTO. There is no trade rules constraint on their use, only countries' willingness to act in the *Spirit of the GATT.*

Recently, however, some major WTO members appear to have begun to abandon the *Spirit of the GATT* when using the loopholes and other facets of the WTO. As a result, the entire international trade law edifice agreed at the end of the Second World War is threatened, with potentially dire consequences for the global trading system. This paper will examine two recent instances where the use of *exceptions* has been as loopholes rather than in the *Spirit of the GATT*. It will then provide some additional examples of the trend to unrestrained use of weak points in the WTO's architecture.

Loopholes

Articles XX and XXI of the GATT lay out the exceptions that are permitted by agreement. Article XX provides the General Exceptions. Government policies that do not conform to the most favoured nation (MFN) and national treatment (NT) can be used to promote or protect the following:

- Public morals
- Human, animal or plant life or health
- Gold or silver trade
- Customs enforcement
- Monopoly laws (competition policy)
- Patents, trademarks and copyrights
- Preventing deceptive practices
- Banning products of prison labour
- National treasures
- Conserving natural resources

- Carrying out an appropriate commodity agreement
- Export restrictions to implement a price-stabilization program.

Some of these are anachronistic, such as the prevention of gold and silver trade or carrying out an appropriate commodity agreement.[2] There could, at times, be situations where all of these could be of legitimate concern to governments. Some have proved contentious, such as those dealing with the protection of human, animal and plant life or health or the conserving of natural resources. These have proved controversial because they are facets of the GATT that can be construed as exemptions that can be used to allow for measures whose aim is to protect the environment (Isaac et al., 2002; Jackson, 1989). Some have obvious limits to how they could be used to circumvent GATT constraints – banning products of prison labour or customs enforcement. Others are only limited by the inventiveness of the trade bureaucrats that think them up.[3] The protection of public morals and protecting national treasures seem particularly open. Who is to say what constitutes public morals or a national treasure – yet they have not often been used. This paper will examine one recent case where the public morals exemption was used.

Article XXI provides an exemption for national security purposes. According to Jackson (1989, 204), "The language is so broad, self-judging and ambiguous that it obviously can be abused." Until recently, it has not been abused. Again, according to Jackson (1989, 204-205),

> Because of this danger of abuse, contracting parties have been very reluctant to formally invoke Article XXI, even in circumstances where it seems applicable. Thus there have been only a few reported cases regarding Article XXI in GATT's history. In general the GATT approach to Article XXI is to defer almost completely to the judgement of the contracting party.

In this paper one example of the use of Article XXI that does not appear to show the normal restraint and be within the *Spirit of the GATT* will be examined. Subsequently, other recent activities that appear to violate the *Spirit of the GATT* will be discussed.

Public Morals

Central to the question of the public morals exemption in the WTO is the problem posed by Nachmani (2013, 33): "how to allow states to regulate matters of moral importance while ensuring they do not abuse this freedom by enacting disguised protectionist measures." If countries hold to the *Spirit of the GATT,* the freedom of unfettered determination of what is encompassed under public morals is not a particular problem. The record of use of the public morals exemption since its inception in 1947 appears to support the noncontentious use of the exemption. For more than 50 years after the

exemption was penned, there were no disputes involving Article XX(a) (Charnovits, 1998). According to Nachmani (2013, 38-39),

> The products banned or restricted by Member States vary widely. For example, Israel has a ban on the import of all non-kosher meat; Indonesia has imposed special restrictions on the importation of all alcohol; and many countries have bans on narcotics, as well as pornography. Other examples include the US ban of all products made by indentured child labour, and the European Community ban on importing furs caught in countries that permit the use of leg-hold traps.

While some of these restrictions on trade may have been contentious among exporters, none challenged the use of the exemption by bringing a formal dispute. The first dispute based on the public morals exemption, brought to the WTO in 2004, pertained to U.S. prohibitions on offshore gambling (Marwell, 2006).[4] A second case, which related to Chinese restrictions on imports of audio and visual materials, was brought by the United States in 2009. China claimed its restrictions were justified, as they were in place to protect public morals. These were the first cases where dispute resolution panels were asked to rule on the public morals exemption. The legal arguments were complicated, but not central to the question related to the appropriateness of the use of the public morals exemption. In neither case was the use of the trade restrictions upheld. As a result, many issues surrounding Article XX(a) were not clarified. According to Nachmani (2013, 45),

> While the *US-Gambling* and *China-Audiovisual* cases were groundbreaking – being the first time that the WTO was required to rule on the public morals exemptions under the GATS and the GATT, respectively – many of the questions that scholars previously struggled with still linger. Perhaps the most important residual question is who has the authority to define public morality? Further, what determines "public morals" from morals simply held by a group of people? How many people, and which people, have to consider an issue to be one of public morality for it to qualify under Article XX(a)?

These questions remain unanswered in the cases brought to the WTO by Norway and Canada regarding the EU's ban on imports of seal products – *European Communities—Measures Prohibiting the Importation and Marketing of Seal Products* (Norway WTO Doc WT/DS401/5, March 15 and Canada WTO Doc. WT/DS400/4, Feb 14). The EU justified the import ban on the basis of protecting public morals. Unlike the examples of products listed above where the Article XX(a) exemption was claimed, the ban on imports of seal products justified on public morals is contentious from the perspective of the producers and exporters of those products. Canada argued, in part, that the EU measures could not be justified on the basis of protecting public morals

(Howse et al., 2015). Given that both Canada and Norway took umbrage at the public morals justification, the ban may not have been encompassed within the ambit of the *Spirit of the GATT*.[5]

While there were considerable nuances and specific legal issues in the judgements of the panel and the Appellate Body,[6] in essence the position of the EU was upheld regarding the public morals justification. More important, the panel and the Appellate Body accepted the EU justification without requiring any evidence that there was a public morals concern in the EU. Of course, determining a threshold for what constitutes a legitimate concern regarding a public morals issue would be extremely complex and fraught with practical difficulties (Howse et al., 2015). Lack of a threshold, however, gives countries a *carte blanche* in determining when public morals can be invoked to impose trade barriers. Appleton (2014) suggests the ruling will open the floodgates to all sorts of protectionism. In reporting the arguments of the *floodgates* critiques of the WTO ruling, Howse et al. (2015, 147) state,

> Essentially, their claim is that the WTO have been too permissive, opening the door to protectionism by WTO members, and that it needs to conduct a more searching inquiry into what qualifies as public morals. Simply leaving it up to states to determine what public morals are (in large part) and not demanding any particular form of evidence to support a public morals claim, introduces the specter of "mixed motives."[7]

One of the major flaws of the WTO, and the GATT that went before it, has only latterly been identified (Perdikis and Kerr, 1999). The economic model upon which the GATT was premised made no provision for the potential for consumers to ask for protection (Kerr, 2010).[8] In the neoclassical-based model that underpins the WTO, consumers are never expected to ask for protection because trade barriers raise the prices they must pay. It is not in their interest. As a result, the WTO focusses on how governments can deal with producers asking for protection. A government cannot justify the imposition of trade barriers based on consumers lobbying for protection.[9] There has, as yet, been no attempt to deal directly with consumers requesting protection at the WTO.

The question of what evidence would be required to justify trade barriers based on consumer concerns, including issues of public morals, remains a vexing one. Would a government have to present evidence that 50 percent plus one of its consumers believed imports compromised public morals? Determining consumer preferences accurately is extremely difficult (Hobbs and Mooney, 2016; Hobbs et al., 2014). Further, policy agendas and lobbying are often driven by a small number of individuals with strong preferences – the majority of members of civil society may be indifferent or either mildly supportive or mildly opposed. In the case of having seal products in the EU

markets there is little doubt that a cadre of animal welfare activists with strongly held preferences was at the forefront of the movement to ban imports. The EU was not required to present any evidence of whether there was a widespread perception that imports compromised public morals.[10]

In the absence of a requirement for evidence to justify trade barriers put in place for reasons of public morals, one has to rely on countries acting in the *Spirit of the GATT* when claiming the public morals exemption. The willingness of the EU to claim the public morals exemption in the case of an internationally controversial issue such as imports of seal products threatens the viability of the multilateral system.

National Security

As noted above, the national security exemption in Article XXI of the current GATT is both a necessary part of the agreement – no country would agree to limit its use of trade measures when it faced what it considered a threat to its national security – and left open to a country to decide what constitutes a threat to national security that can be invoked to justify the imposition of trade barriers. Given the *carte blanche* nature of Article XXI, it relies on countries acting in the *Spirit of the GATT* to prevent its use as a general means to provide protection.

The administration of U.S. President Donald Trump has made no secret of its perception that trade agreements signed by previous administrations are too constraining on U.S. trade and other policy objectives and allow the United States to be taken advantage of by its trading partners (Kerr, 2018b). Although the *Spirit of the GATT* is not specifically mentioned by the president or members of his administration, they consistently act as if it is not a constraint.

To widespread condemnation, on March 1, 2018 President Trump signed an order to impose tariffs[11] of 25 percent on steel imports and 10 percent on aluminum imports. The justification was national security, and the condemnation questioned whether there was a real national security threat.[12] The subtext was that the United States was not acting in the *Spirit of the GATT*. Originally exempt, the EU, Canada and Mexico became subject to the tariffs on May 31, 2018.[13] The EU and Canada, in particular, objected to the imposition of the U.S. tariffs because they represented a threat to U.S. national security. Both cited their long-standing position as U.S. allies. The Trump administration was unmoved by such arguments. It needed a justification for the imposition of the tariffs and Article XXI provided a virtually unchallengeable mechanism to impose them. It represents a successful use of a long-standing loophole but disregards the *Spirit of the GATT*. It is a way to lift the constraints imposed by the WTO, thereby allowing the more aggressive use of trade measures to obtain concessions from other trading partners. It fits well within the narrative that the

constraints of trade agreements signed by previous administrations allow trading partners to take advantage of the United States. There is little doubt that this use of Article XXI weakens the WTO and potentially opens the gates to the widespread and unfettered use of Article XXI for protectionist purposes.

Legal Interpretations and Game Playing

The *Spirit of the GATT* is being ignored in other ways – most obviously by the Trump administration. Dissatisfaction with the WTO dispute settlement system is not unique to the current U.S. administration, but the Trump administration is actively following a strategy to eliminate the constraints on its trade policy actions that the dispute settlement system imposes. In strict accordance with WTO law, appointment of the seven Appellant Body judges, who have fixed terms, should be done through consensus. The United States is refusing to cooperate in filling the positions as they become vacant. Three appeals judges must hear each appeal. Once the number of judges falls below three, which will happen before the end of 2019, appeals can no longer be heard. If appeals cannot be heard, arguably WTO panel rulings will not be valid. Thus, the dispute settlement system will no longer function. This will allow members, including the United States, to use anti-dumping and countervail actions without international oversight.

Decision-making by consensus has been part of the multilateral system almost since its inception, but has not been used to hamstring the organization where consensus is reached by negotiation. Not using the *absence of consensus* as a veto is part of the *Spirit of the GATT*. If the use of such a veto becomes the norm, other aspects of the WTO may not be allowed to function as intended.

The basic strategy of the Trump administration is to use the imposition of tariffs tactically to obtain concessions from trading partners – to use the economic power of the United States to obtain better trade or other policy outcomes. China has been the major target of this strategy (Kerr, 2019). The United States wants concessions in areas where trade measures are not normally allowed, including Chinese requirements for sharing technology and the acquisition of trade secrets through nefarious means. The United States has imposed wide-ranging tariffs on Chinese goods in an attempt to obtain concessions from China. If the concessions are gained, then the trade barriers would be removed. The tariffs the United States has imposed on China have been challenged at the WTO and are likely not compliant with multilateral obligations. Using the dispute settlement system takes considerable time, however, and if concessions are obtained and the trade barriers removed prior to a panel ruling having been obtained and an appeal heard, then the dispute would be withdrawn.

In essence, the United States is gaming the system, betting that it can obtain concessions before a judgement can be rendered. It may also be betting that the dispute settlement system will be rendered inoperable by its failure to cooperate in appointing new appellant judges. It is not clear what the result will be if concessions are not obtained in time and the WTO rules against the United States. In any case, the United States is playing a dangerous game by exploiting the time lags in the dispute settlement system. It is an avenue that has been available to WTO members since the new mechanism was incorporated in the revamped organization in 1994. Refraining from gaming the system in this way can be considered part of the *Spirit of the GATT*.

Conclusions

Loopholes, the ability to exploit strict legal interpretations and to game the system, have been available to GATT and subsequently WTO members since the organization's inception. It is only recently that members have begun to utilize these avenues to push forward their trade agendas. The previous restraint is somewhat surprising given exploitation of loopholes is common, almost expected, for example in the interpretation of tax codes.[14] The reason for this earlier restraint lies in an archaic and somewhat nebulous notion dubbed the *Spirit of the GATT*. It seems a somewhat incongruous anachronism in the modern world, yet it is an important foundation of the multilateral international trade system. Although it is seldom referred to among current trade policy makers, the functioning of the system of international trade law and its institutions depends on member states acting within its spirit. If countries are willing to abandon the *Spirit of the GATT*, as some now appear willing to do, then the GATT/WTO will cease to function as it has since 1947. If this comes to pass, investing in international trade and international commerce will become much riskier than has been the case over the last 70-odd years.

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Endnotes

[1] I was not able to find such a definition despite reading numerous discussions of the *Spirit of the GATT* and having long been aware of the term.

[2] International commodity agreements for agricultural commodities (coffee, cocoa), other resource crops (natural rubber, jute) and some minerals (tin) were popular in the early part of the GATT era (Gilbert, 2007). Their intent was to stabilize markets. The mechanism was to manage supply and trade volumes and, hence, to operate could not conform to GATT principles. As stabilizing institutions they were found wanting and fell out of favour, although some still survive with much reduced roles relative to their initial intent (Gilbert, 2007; Kerr and Perdikis, 2014).

[3] According to Jackson (1989, 201), "… the ingenuity of man in devising import restraints which skirt the formal rules of international trade seems boundless."

[4] Formally, the dispute was brought under GATS Article XVI, which is the corresponding public morals exemption of that WTO agreement.

[5] Of course, this characterization may also be contentious.
[6] See Howse et al. (2015) for a detailed discussion of the case and the judgements.
[7] Howse et al. (2015) go on to dismiss these concerns.
[8] The neoclassical economic model sees consumers only as beneficiaries of trade liberalization because they can purchase goods at lower prices. On the other hand, producers benefit from trade barriers because they receive higher prices – and then have an incentive to lobby governments for protection (Perdikis et al., 2001).
[9] One example that has received a great deal of attention is the EU ban on the import of agricultural products produced using biotechnology. Faced with a backlash from some consumers not wishing to have genetically modified organisms (GMOs) in their food markets, the EU has imposed what are in effect bans on the domestic production and imports of GMOs. In this case, with no means to directly justify its import ban citing consumer concerns, the EU has been forced to attempt to justify its trade barriers based on provisions of the WTO's Sanitary and Phytosanitary Agreement (SPS). The SPS requires a scientific justification for the imposition of trade barriers, or an absence of sufficient scientific information. Neither argument was accepted by a WTO panel (Viju et al., 2012). An earlier case regarding the EU's ban on imports of beef produced using growth hormones, which was justified on SPS grounds, met a similar fate in the WTO disputes system (Kerr and Hobbs, 2005; Hobbs, 2014).
[10]Of course, in a representative democracy elected officials have the role of interpreting public sentiment.
[11] To take effect 15 days later.
[12] The real reason for the imposition of the steel tariffs is worldwide overcapacity in steel production. Across the globe investments in additional steel capacity had been made in anticipation of continued rapid economic growth in China. These expectations were not fulfilled as Chinese growth slowed. As a result, the world is awash with excess steel production capacity. Countries, naturally, are loath to lose the investments and jobs associated with steel production and have found ways to subsidize or otherwise support the retention of the excess capacity put in place by poor decision making in the steel industry. The Trump administration's response to lobbying by the steel industry was the imposition of tariffs – which fits with its trade policy narrative regarding the unfair trade practices and policies of its trade partners.
[13] South Korea, Argentina, Australia and Brazil were able to retain their exemption from the tariff by agreeing to import quotas. Acceptance of import quotas was part of the administration's strategy of using the threat of tariffs to garner trade concessions from trade partners (Kerr, 1918b).
[14] I am indebted to my colleague Tristan Skolrud for pointing this out.