

## THE IMPLICATIONS OF COUNTERTRADE UNDER THE GENERAL AGREEMENT ON TARIFFS AND TRADE

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### 1. Introduction

The proliferation of countertrade practices and their increasing impact on international trade has prompted serious reviews of the nature and extent of such practices. For the most part, these analyses have focused on the mechanics of countertrade and its economic effects. To date, little attention has been directed at the possible implications of countertrade under the rules currently governing the international trading system and embodied in the General Agreement on Tariffs and Trade (the “GATT”) [1]. This article examines the extent to which countertrade practices are consistent with the generally recognized rules of international trade.

Countertrade practices as such have not been seriously considered in the GATT. This lack of attention may be attributed to several factors. Countertrade is most often used by nonmarket economy countries, few of which have joined the GATT [2]. Moreover, because trade with these countries is relatively modest, private companies and the U.S. Government have preferred to encourage trade rather than complain vociferously about countertrade practices where they have arisen [3]. Countertrade has been viewed as a necessary evil to be tolerated because of a desire to encourage trade while accommodating the foreign exchange needs of most nonmarket economies. Recently, however, countertrade has become a matter of serious concern because its use has become more widespread. Countertrade practices are popular in developing countries. Some developed countries have also encouraged such deals, especially with developing countries, in order to secure access to raw material [4].

Analyzing countertrade with respect to the GATT will prove helpful for several reasons. First, an examination of countertrade in terms of the GATT demonstrates the fundamental incompatibility between countertrade practices and the framework for trade envisioned by the GATT drafters. Second, the GATT rules may provide analogies from which principles may be drawn to govern the use of countertrade. Finally, to the extent that the GATT rules

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cannot be used to deal with the trade-distorting effects of countertrade, new rules must be developed.

## 2. The structure of GATT

The GATT is essentially a contract among sovereign nations under which they mutually agree to limit their freedom of action to regulate international trade [5]. The centerpiece of this system is a set of tariff schedules specifying the maximum rates that GATT members may charge as customs duties [6]. For almost thirty-five years and through seven rounds of multilateral negotiations, GATT members have concentrated their efforts on the elimination of tariffs. Their success in this endeavor is evidenced by the generally low level of tariffs, which may be responsible for an increase in international trade.

The elimination of tariffs as a major obstacle to trade has shifted the focus in the GATT to the set of rules that initially were designed to protect the value of tariff concessions [7]. Several attempts have been made over the years to improve the basic framework. The most recent attempt occurred at the Tokyo Round of Multilateral Negotiations during which codes of conduct were developed to augment the rules regarding subsidies, dumping, customs valuation, standards, and government procurement [8].

Taken together, the rules promulgated under the GATT constitute the legal norms against which any form of governmental intervention in international trade may be tested. In determining whether countertrade is consistent with the GATT principles, both the nature of the countertrade and the extent of governmental involvement in this practice must be examined.

## 3. What is countertrade?

For purposes of this analysis, the term "countertrade" refers to the entire range of practices whereby one country requires another to purchase from it as a condition for allowing that country to sell to it. The following aspects of countertrade are relevant to a GATT analysis: (1) the refusal to comply with a countertrade requirement bars a sale from the noncomplying party to the party imposing the requirement; (2) countertrade requirements have trade-distorting effects that are not present in normal transactions in international trade; (3) countertrade practices create risks for sellers that are not compensated for by any significant advantages; and (4) countertrade is used to balance trade on a product, transaction, or country basis. These effects have been identified in the economic literature on countertrade. Although they may or may not be present in a particular transaction, they are taken as given for purposes of the following GATT analysis.

#### 4. The nature of governmental involvement in countertrade

The GATT rules regulate the behavior of governments, not individual business entities [9]. As indicated above, an examination of the consistency of countertrade with the GATT rules requires an examination of the extent of government involvement in countertrade practices.

Two extremes of governmental involvement exist. In the first situation, if a firm decides on its own to discriminate against imports or to impose certain conditions upon importation (*e.g.* barter, buybacks, swaps), the decision cannot be challenged; the GATT does not govern the decisions of commercial entities. If, however, the country where the firm is located has a “buy national” policy, the existence of this policy creates a presumption that some form of state coercion is being used to influence the firm’s actions. In such a case, the GATT rules would apply to the government involvement but not to the activities of the private parties.

At the opposite extreme is the state-controlled economy. Although the drafters of the GATT considered this situation, they decided to deal just with the problem of state trading enterprises and not with the problem of state-controlled economies. Article XVII of the GATT imposes upon state trading entities a rule of nondiscrimination and requires them to act solely in accordance with “commercial considerations”. Through the provisions of this Article, the drafters attempted to approach state trading in the same manner they dealt with governmental regulation of private trade.

The two situations discussed above raise the question of whether countertrade practices are the results of deliberate state regulation, and, if so, what form that regulation takes. The discussion below focuses on three different contexts in which countertrade practices may arise: (1) those where countertrade is required by law or regulation in an otherwise nonstate-controlled economy; (2) those where countertrade is practised by a state trading enterprise, whose decisions cannot be easily characterized as either commercial or noncommercial, in an otherwise nonstate-controlled economy; and (3) those where countertrade is practised in a state-controlled economy. As state control over the entire economy becomes more pervasive, the GATT framework becomes less relevant because the GATT was designed to allow the free market to function in an unimpeded fashion by placing limitations on government interference with trade.

The GATT does not prohibit governmental protection of private trade agreements, but does require such protection to take the form of tariffs. The GATT also calls upon countries to negotiate the elimination of tariffs. The GATT rules on nontariff measures attempt to restrict the use of other forms of regulation. The more an economy is subject to complete state control, however, the more avenues there are to frustrate the GATT scheme in ways that simply were not anticipated by the drafters.

## 5. Countertrade by law or regulation

Instances in which countertrade is required by law or regulation in an otherwise free market economy are not common. Of the various forms of countertrade, only offsets appear to be a common occurrence in developed market economies. An examination of countertrade in this context is the starting point for any overall GATT analysis because this is the context that the drafters had in mind when designing the rules [10]. If imposed by law or regulation, countertrade conflicts with a number of fundamental GATT rules. Recognition of this fact makes it easier both to appreciate the problems posed for the GATT when countertrade is practised by state-controlled economies, and to understand why a different regime is necessary for managing trade relations between East and West.

The following subsections demonstrate, first, that countertrade practices have economic effects that directly conflict with the framework the GATT was designed to preserve. Such practices are an instrument for direct governmental regulation of trade and can be used to create the same distortions as a quota or a tariff. Second, these sections establish a strong case that countertrade practices violate any of a number of specific GATT Articles, including those designed to protect against nullification or impairment of tariff concessions, those requiring nondiscrimination (most favored nation ("MFN") and national treatment), and those prohibiting quantitative regulations.

### *5.1. GATT nullification or impairment*

The basis for a GATT member's challenge of the practices of another contracting party is Article XXIII. This article authorizes a complaint in any case in which a member feels that

any benefit accruing to it directly or indirectly...is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as a result of:

- (a) the failure of another contracting party to carry out its obligations..., or
- (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of [the GATT], or
- (c) the existence of any other situation.

Article XXIII directs the parties to consult about the matter and, if no settlement is reached, the contracting parties, acting in a judicial capacity, may hear the complaints and make recommendations to the parties or give a ruling "as appropriate" [11]. If the circumstances are "serious enough", the contracting parties may authorize a specific form of retaliation: the complaining party or parties may suspend the application of "concessions or other obligations" under the GATT to any other contracting party or parties.

Both the GATT precedent and the understanding on the GATT dispute

settlement mechanism, embodied in the Framework Agreement reached during the Tokyo Round negotiations, establish that any government measure violating a GATT provision constitutes a *prima facie* nullification or impairment of a GATT benefit [12]. Once an infringement of a provision is shown, the burden of proof shifts to the offending government to prove that nullification or impairment of a GATT benefit has not occurred. If the accused country fails to produce substantial evidence, the contracting parties must determine whether the circumstances are serious enough to justify authorization of remedial actions.

A more difficult case is presented when a complaining party alleges nullification or impairment as a result of a practice not explicitly prohibited by the GATT. Nevertheless, GATT panels have determined that certain practices constitute nullifications or impairments, even though they do not conflict with any particular rule. Such cases arise where the foreign practice upsets the balance of concessions that have been negotiated in a trade agreement [13].

### 5.2. *Most-favored-nation treatment*

Article I of the GATT requires that contracting parties treat the products of every other contracting party no less favorably than they treat the products of the most favored nation. A strict reading of the language of Article I supports the view that a countertrade requirement applying equally to all foreign countries would not be inconsistent with this obligation because all foreign countries are subject to the same requirement. Despite this view, countertrade practices conditioning access to a country's market on purchases of an equivalent amount of that country's goods are strongly reminiscent of the bilateral arrangements which the unconditional most favored nation principle was designed to prevent. Moreover, an extension of the logic of countertrade would allow a country to negotiate a countertrade deal that covered all of its exports to the importing country in return for equivalent purchases. This type of bilateral balancing of trade is fundamentally inconsistent with Article I's purpose of preserving the multilateral character of the GATT system.

### 5.3. *Tariff concessions*

Article II, paragraph 1, of the GATT incorporates into the basic agreement the tariff schedules of each contracting party and requires that the protection afforded any product be no greater than that provided for in the member's schedule. Protection provided by countertrade requirements would be contrary to this principle unless the contracting party had included the countertrade requirements as a condition in its GATT schedule.

Article II, paragraph 4, addresses the situation where a contracting party "establishes, maintains or authorizes, formally or in effect, a monopoly of the

importation of any product”, and it stipulates that such a monopoly cannot be used to provide protection “on the average in excess of the amount of protection provided for in [the] Schedule”. This provision could be used against countertrade practices when the government of a country enforces the countertrade requirement through an import monopoly that has been established either formally or in effect.

#### 5.4. National treatment of internal taxation and regulation

Article III of the GATT states the basic principle of nondiscrimination in the treatment of imported goods. It requires the taxation and regulation of imports in the same manner as domestically produced goods. The basic rule of paragraph 1 provides that.

laws, regulations and requirements affecting the internal sale of, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

Countertrade requirements could be construed as quantitative regulations of the use of imported products in specified amounts or proportions: the quantities of products to be purchased and used by the importing country are tied to the foreign country’s purchases of the former’s locally-produced goods. The practice thereby protects domestic producers by forcing the foreign exporter to purchase goods in the domestic producer’s own export market rather than from competitors.

Paragraph 5 of Article II provides a more direct basis for challenging countertrade practices. It bans quantitative regulations “relating to the... use of products in specified... proportions which” require that the specified “proportion of any product... must be supplied from domestic sources”. This provision has been used to challenge practices requiring a party to purchase a certain amount of a local product as a condition for the party’s sale of another product. The European Economic Community in one case required domestic importers and producers of animal feed in member states to purchase specified quantities of dry milk for use in such feed. A GATT panel held this requirement to be a violation of Article III [14]. The same logic could be applied to countertrade requirements.

In addition, paragraph 4 requires that rules forbidding the “internal sale, offer for sale, purchase, transportation, distribution or use” be no less favorable for imports than products of national origin. This provision could be used against countertrade requirements that tie the level of imports to a required level of exports.

### *5.5. General elimination of quantitative restrictions*

With the exception of duties, taxes, or other charges, Article XI of the GATT prohibits restrictions on imports and exports, whether made effective through quotas, licences, or “other measures”. Countertrade requirements can operate as quantitative restrictions on imports. If a firm is unable to export to a country unless it accepts a countertrade requirement, the effect of the requirement is no different from the effect of a conventional import quota adjusted according to some domestic market criterion. For example, if a country established a quota on the importation of a given product and then adjusted the quota in accordance with the level of exports, the quota would violate Article XI. Countertrade requirements have the same effect on individual firms and, therefore, violate one of the most significant GATT provisions.

## **6. State trading enterprises**

Article XVII of the GATT provides that state enterprises or firms receiving “exclusive or special privileges” from their respective governments must be permitted to make purchases and sales involving imports or exports in a manner: (a) consistent with the “general principles of nondiscriminatory treatment” contained in the GATT, and (b) solely in accordance with commercial considerations [15].

Paragraph 1(c) of Article XVII applies these principles not only to controls on “state enterprises”, but to any firm under the jurisdiction of the host government [16]. This provision is redundant in the context of a countertrade requirement imposed directly by law or regulation. It could, however, be used in situations involving indirect regulations, such as conditioning the receipt of government financing, tax breaks, or other government assistance on acceptance of countertrade obligations.

### *6.1. The GATT and state trading*

The dilemma posed by state trading practices for the drafters of the GATT is comparable to that confronting today’s policymakers in their efforts to grapple with countertrade issues. The drafters recognized that state monopolies can exercise their discretion to buy or sell on a discriminatory basis and thereby circumvent the GATT rules [17]. This problem is compounded by the difficulties of detecting and measuring the impact of such practices when decisions are made without public scrutiny or disclosure. Moreover, the drafters faced the practical reality that many countries utilized state monopolies to secure revenue or regulate the trade in certain commodities.

The drafters established some useful principles in Article XVII for dealing with state enterprises, but the rules fall far short in their actual application. Article XVII is drawn from the corresponding provisions of the International Trading Organizations' Charter ("ITO Charter") [18]. This Article, also based on an ITO Charter proposal of the United States [19], reflects an attempt to treat state trading in a manner that is comparable to the GATT treatment of governmental regulation of private trade.

## 6.2. *Article XVII and state trading*

As indicated in subsection 6.1 *supra*, the basic rule of Article XVII is that state enterprises are not allowed to discriminate in a manner inconsistent with the principles of nondiscrimination set forth in other parts of the GATT. There is some debate over whether this principle of nondiscrimination is intended to encompass both national and MFN treatment or only MFN treatment. The broader interpretation of nondiscrimination coincides with the basic U.S. objective of subjecting state trading enterprises to the same principles applicable to government regulation of private trade. Although on one occasion the United States argued before a GATT panel for the broader interpretation, it elected to settle the case before a panel decision was issued. The continuing ambiguity in the scope of the nondiscrimination principle is evidence of the desire of the United States and other GATT members to avoid the tough questions in dealing with state trading.

Paragraph 1(b) of Article XVII adds to the principle of nondiscrimination the requirement that state enterprises shall "make any such purchases or sales solely in accordance with commercial considerations, . . . and shall afford the enterprises of the other contracting parties adequate opportunity, in accordance with customary business practice, to compete for participation in such purchases or sales". Application of the principles of "commercial considerations" and "opportunity to participate" to countertrade practices, as well as the application of paragraph 1(a)'s principle of "nondiscrimination", involves some major interpretative difficulties. The principles in both paragraphs are vague and, despite the expectations of the U.S. drafters, no case law involving the interpretation of Article XVII has emerged. Nevertheless, a strong case can be made that countertrade involves both discriminatory effects and considerations alien to those present in normal commercial transactions in violation of Article XVII.

Paragraph 4 of Article XVII could also prove useful in dealing with countertrade. This subsection refers to the disclosure of information relating to the operations of state monopolies. Under this paragraph a GATT member may be called upon to supply information about the operations of any state enterprise related to the administration of the GATT. This notification requirement, adopted as an amendment to the GATT in 1957, has been implemented



through a formal notification process. Every three years, countries maintaining state enterprises are called upon to complete a GATT questionnaire designed to elicit detailed information on the operation of state trading enterprises. In particular, the questionnaire requests disclosure of the criteria used by the enterprise to determine the quantities to be exported and imported. This questionnaire, either in its present form or as appropriately amended, could be used to elicit valuable information on countertrade practices; the information could then be used as a basis for a careful scrutiny of such practices under the GATT.

Finally, in addition to Article XVII, two other GATT rules are also applicable to state trading. Article II, paragraph 4, requires that the protection afforded by a state monopoly not exceed that provided for a particular product in a country's Schedule of Concessions. Article XI, which prohibits quantitative and other restrictions, expressly applies to state trading enterprises by virtue of an Interpretive Note in Annex I. Thus, it can be argued that countertrade practiced by state enterprises is inconsistent with the principles of Article II regarding products covered by a tariff concession and Article XI.

## 7. State-controlled economies

Although the GATT text does not address the problems of accommodating state-controlled economies, except to the extent of imposing certain criteria on the operation of state enterprises, these problems were considered in the early GATT negotiations. When the Soviet Union withdrew from those negotiations, these problems became moot, and the provisions designed to deal with state-controlled economies were eliminated from the GATT draft [20]. This omission was intentional because it was thought that the GATT would not have to address the problems presented by membership of such states because the ITO, with its more comprehensive provisions, was expected to take effect within a short time. The eventual rejection of the ITO meant that the GATT had to accommodate state-controlled economies. In spite of silence in the GATT agreement, *ad hoc* solutions have evolved to deal with the handful of state-controlled economies that have joined the GATT since 1948.

One proposal, included in the 1946 ITO draft prepared by the United States, but not included in the final ITO draft, required that a country with a complete or substantially complete monopoly of its import trade be willing to undertake global import commitments. The requirements of this provision were imposed on Poland when it sought membership in the GATT in 1967. In its Protocol of Accession, Poland undertook to increase the total value of its imports from other contracting parties by "not less than 7 percent per annum" [21]. The Polish formula is significant for purposes of approaching countertrade issues because it represents an alternative to the problematic application

of GATT rules to an economic system that does not fit within the GATT framework.

## 8. Conclusion

Countertrade poses serious issues in terms of basic GATT obligations. The problems are exacerbated by the fact that countertrade is most commonly used by state-controlled economies; the GATT rules are difficult, if not impossible, to reconcile with those countries' extensive government involvement in commercial decisions. From a practical standpoint, it may be desirable to acknowledge this conflict and create an exception for countertrade to the GATT rules to draw these countries into the trading system. One should not ignore, however, the threat that countertrade poses for the GATT system should its popularity spread.

## Notes

[1] General Agreement on Tariffs and Trade, *opened for signature* October 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187. The GATT has been amended a number of times since 1947. The current version is contained in 4 General Agreement on Tariffs and Trade, Basic Instruments and Selected Documents (1969).

[2] Of the nonmarket economy countries only Poland, Hungary, Czechoslovakia, Romania, and Yugoslavia are currently members of the GATT.

[3] This pragmatic view of the importance of trade with nonmarket economies has been an important aspect of the age of detente. For a review of issues affecting East-West trade and U.S. policy, see *East-West Trade, An End to Business as Usual*, *The Economist*, May 22, 1982, at 55.

[4] See *Bartering Aids Poor Nations*, *New York Times*, Jan. 17, 1983.

[5] See, generally, R. Hudec, *The GATT Legal System and World Trade Diplomacy* (1975); J. Jackson, *World Trade and the Law of GATT* (1969).

[6] GATT Article II states, in part: "[e]ach contracting party shall accord to the commerce of the other contracting party treatment no less favourable than that provided for in the appropriate Part of the appropriate Schedule annexed to the Agreement". GATT, *supra* note 1, at Art. II, para. 1(a). These schedules have been subject to modification negotiations through successive rounds of negotiation, the latest of which was concluded in 1979 and is embodied in Geneva (1979) Protocol to the General Agreement on Tariffs and Trade, vols. I-IV, June 30, 1979, General Agreement on Tariff and Trade, Basic Instruments and Selected Documents 3 (26th Supp. 1979).

[7] Twenty-Fourth Annual Report of the President of the United States on the Trade Agreements Program 39 (1979). These rules are a modest reflection of the Charter of the International Trade Organization that failed to achieve ratification in the U.S. Congress. The official text of the Charter is found in Final Act and Related Documents, United Nations Conference on Trade and Employment, U.N. Doc. ICITO/1/4 (1948) [ITO Charter]. See, generally, C. Wilcox, *A Charter for World Trade* (1949).

[8] These agreements are reprinted in *Agreements Reached in the Tokyo Round of the Multilateral Trade Negotiations*, H.R. Doc. No. 153, 96th Cong., 1st Sess. (1979).

[9] See, generally, Jackson, *supra* note 5, at 329.

[10] The argument against countertrade when imposed by law or regulation is similar to the argument against trade-related performance requirements, such as local content and export requirements. Some of the economic effects of countertrade resemble those resulting from performance requirements. One major distinction between the two is that performance requirements are typically imposed as a condition for foreign investment while countertrade is not. See Fontheim & Gadbaw, *Trade Related Performance Requirements under the GATT-MTN System and U.S. Law*, 14 Law & Pol'y in Int'l Bus. 129 (1982). Sections of this paper have drawn from that article.

[11] Article XXV indicates that "Contracting Parties" refers to the representatives of the GATT members who are acting jointly to implement and further the objectives of GATT.

[12] See Uruguayan Recourse to Article XXIII, General Agreement of Tariffs and Trade, Basic Instruments and Selected Documents 100, para. 15 (11th Supp. 1963), GATT Doc. L/1923.

[13] See Hudec, *Retaliation Against "Unreasonable" Foreign Trade Practices: The New Section 301 and GATT Nullification and Impairment*, 59 Minn. L. Rev. 461 (1975).

[14] EEC Measures on Animal Feed Proteins, General Agreement on Tariffs and Trade, Basic Instruments and Selected Documents 64, 65, paras. 4.5-4.9 (25th Supp. 1979), GATT Doc. No. L/4599.

[15] GATT, *supra* note 1, at Article XVII, para. 1(a), (b).

[16] Subparagraph 1(c) states the coverage of the Article XVII principle:

No contracting party shall prevent any enterprises (whether or not [a state] enterprise described in sub-paragraph (a) of this paragraph) under its jurisdiction from acting in accordance with the principles of sub-paragraphs (a) and (b) of this paragraph.

Thus subparagraph (c) appears to broaden the scope of Article XVII to all enterprises under the jurisdiction of the state. Jackson, *supra* note 5, at 339, 344.

[17] See Jackson, *supra* note 5, at 333.

[18] See ITO Charter, *supra* note 7, at Articles 29-30, 32.

[19] U.S. Proposals, Dep't of State Pub. No. 2411, at 17 (1945).

[20] See, e.g., Jackson, *supra* note 5, at 334, 335.

[21] Protocol for the Accession of Poland, General Agreement on Tariffs and Trade, Basic Instruments and Selected Documents 52, Annex B, para. 1 (15th Supp. 1968).

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