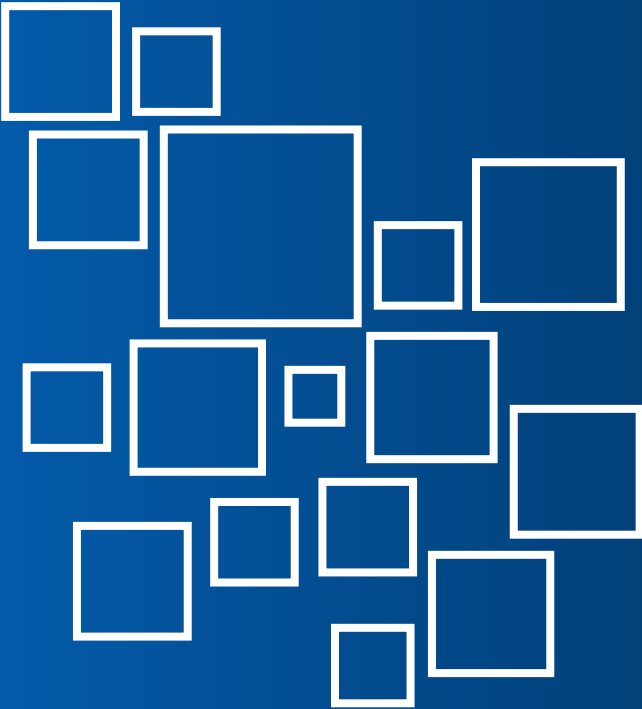


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From Coordination to Collaboration: explaining international disputes over tariff classification

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RESUMO

Será que Estados utilizam mudanças nas classificações tarifárias como forma de se desviarem de seus compromissos comerciais? Este artigo pretende discutir algumas das implicações do sistema corrente de classificação de mercadorias sobre o comportamento dos Estados. Pelas disputas atuais, parece que apenas os aspectos técnicos dos bens não explicam as controvérsias em torno da classificação. Ao aplicar o individualismo metodológico, defendemos que a classificação das mercadorias, que poderia ser descrita como um jogo de coordenação inicialmente, é alterada pela introdução de acordos comerciais e pode ser melhor caracterizada como um jogo de colaboração. Conclui-se que a classificação torna-se uma ferramenta que permite aos Estados se desviarem de forma oportunista das regras da Organização Mundial do Comércio (OMC). Concluímos então, levantando algumas questões sobre a forma como o sistema atual lida com o comportamento oportunista e se a existência de dois mecanismos de resolução de litígios, um na Organização Mundial das Alfândegas e outro na OMC, é adequada.

Palavras-chave: Classificação Tarifária; OMC; OMA; Sistema de Codificação e de Descrição de *Comodities* Harmonizada.

JEL: F13; K33

ABSTRACT

Are changes in tariff classification of goods used by States to deviate from their trade commitments? This article intends to discuss some of the implications of the current system of classification of goods on States' behavior. From current disputes, it seems that technical aspects of goods cannot alone explain the controversies surrounding classification. By applying methodological individualism, we argue that the classification of goods, which could initially be described as a coordination game, is changed by the introduction of trade agreements and can be then better characterized as a collaboration game. It follows that classification becomes a tool that allow States to opportunistically deviate from the World Trade Organization (WTO) rules. We then conclude by raising some questions on how the current system deals with opportunistic behavior, and whether the existence of two dispute settlement mechanisms, the one at the World Customs Organization and the one at the WTO, is adequate.

Key words: Tariff Classification; WTO; WCO; Harmonized Commodity Description and Coding System.

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1. Introduction

In order to exchange goods at the market, people must know what they have to offer, and what they want in return for it. If parties can no longer actually meet at the market, inspect the goods, and have a detailed conversation with the owner, a way of precisely describing the merchandize will be required. This role is fundamentally fulfilled by the use language. By saying that you need, for instance, *shoes*, you express your necessity in a simple and understandable way. However, at least two difficulties arise. Firstly, when international trade is concerned, different languages might hamper communication. Depending on the situation, words such as *Schuhe*, or *sapatos* might not be obvious to the other parties involved. Secondly, how can someone be sure, without conducting an examination, that the offered shoe is indeed what one thinks a shoe should be? Shoes might be manufactured with different raw material, such as animal leather, which can then be from bovine or caprice, and also plastics, fabric, and many other components. They might as well come in different shapes, and sizes. These linguistic problems have very concrete impacts on trade. They demand considerable investment on information and communication, raising transaction costs. One way of overcoming these issues would be by creating a “common/technical” business language for global trade, and indeed, common efforts in this direction have already been undertaken by states at least since 1900². Today, the most popular system is the Harmonized Commodity Description and Coding System (HS), whose convention has been signed by over 135 States, comprising a significant amount of global trade³.

The HS system is composed of different classification⁴ levels of growing complexity. At a general level, sections and chapters make a rough separation, and are followed by chapters. Each chapter is then composed of more specific groups of products for which a numerical nomenclature⁵ is given. The nomenclature is composed of heading of 4 digits and then a complementary double digit element, in a total of 6 digits is provided, forming the HS Code.

The system of classification works as a basic standard for countries, which might then introduce sub nomenclatures by adding until two sets of double digits to the HS Code, in a total up to 10 digits. For instance, Section I of the HS nomenclature is named “Live animals; animal products”, its first chapter is reserved for “Live animals”, its first heading “01.01” for “Live horses, asses, mules and hinnies” which is then subdivided into the code “0101.10” for “Pure-bred breeding animals” and the code 01.01.90 for “others”. Until this point, the nomenclature is equal to all countries that apply the HS System, but States can introduce further digits in order to better specify the good. Brazil, for example, following Mercosur’s Common External Tariff, then differentiates between regular horses and those that are pregnant or lactating⁶.

² For elements on the development on the classification system, see. V.S.Kolesnikoff, ‘Commodity classification’, in R.G.D. Allen, and J.E.Ely (Eds.), ‘International trade statistics’, (London & Tonbridge, Whitefriars Press, 1953), p. 63.

³ For documents and member states see. , World Customs Organization, <wco.org>, 10 August 2011. They also claim the share of trade covered by the HS system to be 98%.

⁴ The act of classifying a good is to be understood as fitting a determined good into one existing nomenclatures of the HS system. However, the general term “classification” will be used rather openly, meaning not only the act of classifying, but also the group of nomenclatures that compose the HS System, and sometimes as a synonym of nomenclature. The term Standard will be used as a synonym for “classification” and “nomenclature”.

⁵ Nomenclature is to be understood as the act of systematically naming or enumerating goods.

⁶ See ‘Common External Tariff (CET) of the Mercosur as applied in Brazil’, <receita.fazenda.gov.br>, 29 May 2012.

Table 1: Overview of the HS Code formation

Section	Chapter	Heading	HS Code	Domestic sub-code
I	01	01.01	01.01.10 and 01.01.90	01.01.90.11
“Live animals; animal products”	“Live animals”	“Live horses, asses, mules and hinnies”	“Pure-bred breeding animals” or “others”	“Pregnant or lactating”

Source: WCO and Mercosur

In addition to this detailed system of nomenclature and classification, particular sets of products are commonly aggregated for operational purposes by academics or policy makers. International Agreements, for example, often have their application limited to certain headings or chapters, creating specific classifications that were not defined as such in the HS system. A typical example -, which will be explored throughout this paper, is the one distinguishing industrial and agricultural products. This distinction, seems to be implicit in the HS System, but is better developed in the WTO Agreements, having important consequences to trade and to State action, as we will discuss in section 3.

Despite some apparent obviousness of the act of classifying a product, the issue is not evident. Situations might arise in which products bear characteristics of more than one HS Code. Think for example of computers that receive television signal. Are they to be classified under television or computer? What about cell phones which work both as computers and televisions? This example illustrates that it can be rather complicate to find a proper classification among hundreds of very specific headings. The introduction of greater distinctions in classification, such as the distinction between agricultural and industrial products, brings further complexities.

Think for instance of a shoe. As it is manufactured, one would immediately assume it to be an industrial good. But what if the shoe is made entirely of natural bovine leather? Is natural leather, i.e. tanned skin, an industrial good? What about raw skin? Where should one draw the line?⁷ How much transformation or technology is needed in a product to deem it “industrialized”? The issue is particularly relevant as technology either spreads to unexplored domains, such as genetically modified organisms, or speeds up the creation of new products, as has commonly been the case of computer engineering.

Setting that aside, it might be interesting to ask why states have found the necessity to cooperate on classifying products in the first place, and why is this relevant today. We think that cooperation in products classification has both a *value in itself*, as it works to reduce trade costs associated with the existence of different sets of complexes rules among trade partners, and an *auxiliary value*, giving support to the GATT/WTO system of trade negotiation for market access and definition of positive rules against non-tariff barriers. The objective of this paper is to understand whether and how the current international rules have dealt with both functions of the classification system.

⁷ The complexity of the issue spreads to other agreements. The Agreement of Agriculture (AoA), for instance, applies to raw skin, but not to tanned skin. See Annex 1 of the AoA.

This endeavor seems justifiable (as the issue of classification of goods has received little attention in the economic and legal literature. Many concerned papers⁸ have already identified the relevance of the topic, but have not done more than simply pointing out its need of more in depth research. We intend to explicitly address the issue of classification. For that, we are mainly concerned with the structure of international agreements that address the matter, focusing on those under the auspices of the *World Customs Organization* and the *World Trade Organization*. Likely problems to be faced include questions such as: Why do States sign international agreements on issues of product classification? What are the main entitlements of such an agreement? What is the correlation with international trade? Have the agreements established a coherent system of entitlement, entitlement protection, and enforcement? Can opportunistic behavior be avoided or properly punished?

In order to address these and other questions, we will draw from the literature on contract law and on the doctrine of incomplete contracts, as well as on issues of contract formation and design⁹.

2. Why to Classify in the First Place?

It has been argued somewhere else that “to classify is human” (Bowker & Star, 1999). The act of classifying emerges in both simple and complex activities, surrounding and influencing most aspects of our life and behavior. Classification is particularly important for science, as it allows us to gather elements with similar characteristics together, facilitating our communication, our analysis, and our understanding of things. In a sense, classification reduces information costs that would otherwise be too high to allow for a proper cognition and expression of complex things. However, this has not only an informative effect, but a directive, or political one. Bowker and Star (1999, p. 319) argue that once a classification has been adopted, its origins (and sometimes the comprehension of the classification as itself), become invisible, creating the impression that a rule, that has actually been chosen by dark-suited men in a smoky room, with well-defined interests, has been spontaneously developed by social behavior. As instrument for information, and also control, classification is not only used by individuals, but also by firms - think for one second of formularies, departments, and concepts such as buyers, sellers and consumers - and by states, who classify, for instance, their inhabitants as tax payers, economically active, retired, civilian, farmers, students, criminals and so forth.

In the field of international trade, classification of products has received a great deal of attention by policy makers and also by firms that elaborate more and more standards for products and business practices¹⁰. We will rather focus on the “public international” rules of classification as they have been described in section 1, i.e., mainly those of international agreements on the nomenclature of products and its relation to international trade. That being said, one should discuss

⁸ For some examples see R. Howse and A. L. Eliason, ‘Domestic and international strategies to address climate change: and overview of the WTO legal issues’, in T. Cottier, *et al.*, *International trade regulation and climate change*, (Cambridge, University Press, 2009); and T. Harmer, *Biofuels subsidies and the law of the WTO* (Geneva, ICTSD, 2009, p. 10).

⁹ Once our framework has been set, we will discuss its application for a concrete and on-going controversy, i.e., the issue of biofuel classification. We expect to show that the apparent insolubility of this dispute has to do, at least partially, with the design of the treaties that rule international trade and international classification, especially insofar as entitlement definition and protection are concerned.

¹⁰ The issue of private standards is a hotly debated and interesting topic, but it will not be addressed in this paper.

some of the possible reasons for the classification of products. We believe that there are two basic approaches to the issue, a first one based on transaction costs that disharmonized rule have on trade, and a second that understands classification rules as being connected to the market access commitments that compose the GATT/WTO.

In both cases, we will use a rational choice approach based on methodological individualism. It is our general assumption that states behave in a certain coherent logic, and that the interaction of states will differ based on the costs and payoffs they might attain by cooperating with one another. In this sense, cooperation can be understood in terms of game theory¹¹. According to Martin (1993) international cooperation can either be represented in terms of collaboration or coordination games. In collaboration games, equilibrium outcomes are suboptimal and both players have to agree to move towards the optimum outcome. Instruments for cooperation include extending the shadow of the future, and relying on international organizations. These games provide strong incentives for defection, so mechanism to preserve cooperation focus on maintenance of equilibrium, usually by (i) extensive monitoring on compliance; and (ii) extending the shadow of the future, as a means to make sure that long term benefits will be higher than short term costs. As maintenance often assumes a centralized form, there is a significant role for organizations. Coordination problems, on the other hand, have two equilibrium outcomes, one of which can be preferred by each of the players. The dilemma is to decide which equilibrium will prevail. As the result will impact on distribution, bargaining will be intense, but, once one has been chosen, there are no incentives to defect. Therefore, these games do not require strong mechanisms for surveillance and enforcement, but rather instruments to facilitate bargaining (Martin, 1993, p.96). Due to the complexity of real circumstances, it is likely that many cooperative situations are actually composed by both elements. Therefore, when we refer to one of them, we do not mean that the other is completely absent, but simply that, in our view, the one we refer to is the dominant one.

As we will argue in section 4, the current classification system has both elements of coordination as well as collaboration game. This duality certainly poses difficulties for a proper regulation of the matter.

3. Is Classification a Game?

It is our opinion that the classification of things, understood as a process of attributing (common) names based on their differences and similarities, resembles a coordination game structure. One argument that could be put forward to support this view states that by giving common names to similar things we facilitate communication and reduce transaction costs between parties, making everyone better off. However, if certain privileges (values) are attributed to a given class of things, or when classes are not subjected to change to respond to modifications in reality – including the emergence of new things that have to be named (both with an already existing name or through the creation of a new name) - the scenario changes into a collaboration game.

We believe that the issue of international product classification can fall within both categories, depending on whether states intend to elaborate a purely descriptive list of classification, what we will name as *descriptive classification*, or whether they intent to assign excludable rights to groups of objects, hereinafter *normative classification*. We will now try to demonstrate this assertion

¹¹ International law is commonly understood in terms of cooperation problems, for which game theory is particularly well designed method. See, for instance, A. T. Guzman, 'How international law works – a rational choice theory' (Oxford, University Press, 2008, p. 25).

by describing the circumstances under which classification can be understood as a coordination game and also those of a collaborative game. With that in mind, we will then proceed to analyze the current international rules on classification and their connections to trade rules.

3.1. Descriptive Classification *or* the Coordination Game of Classification¹²

As a coordination game, classification should help states to overcome a problem of transaction costs created by the existence of different domestic rules on classification, i.e., by the existence of different languages or different names attributed to similar products. When two completely different sets of rules coexist, transaction costs reduce payoffs of both states. If countries cooperate, by creating a common nomenclature for products, they avoid these costs, raising their final payoff. In theory, it is possible for them to either create a new common system of classification, in which both contribute to the elaboration of the new rule and give up on their old one – we believe this situation resembles a pure coordination game – or simply for one of them to adopt the other's, in which case one of them would hold a slightly higher payoff for already having the system knowhow, resembling a battle of sex game. To sum up, we have either a pure coordination game (if they develop a new language system) or a battle of sex (even though the difference in payoffs would probably be low) if they adopt one of the two system (assuming that both already have a classification system, and that both prefer their language system over the other). Following this, we should have¹³:

Table 2: Classification as a Coordination Game

Pure Coordination		Battle of Sex	
		B	
A		Nc	Cb
	Nc	9,9	0,0
	Ca	0,0	5,5

		B	
A		Ca	Cb
	Ca	10,9	5,5
	Cb	5,5	9,10

Nc= Adopts a new classification system

Ca= Adopts or remains with the classification system of A

Cb= Adopts or remains with the classification system of B

In order to avoid a classification system from privileging certain products, i.e., in order for a system to be purely “descriptive” and not “normative”, it is a logical condition that, (i) classes of things are not attributed different rights; and that (ii) all existing things have been named, assuming also that these (i) do not require their names to be changed; and (ii) there are not “new things” that will require new names. Assuming, however, that in reality it is impossible to have all things classified, either because they might be deemed to better fit a different classification (or even more than one), or because new things have been discovered or invented, a descriptive classification

¹² If it is a coordination game, why do we have a treaty on it? Because we might be facing a battle of sex game, and parties have to define how the payoffs are going to be shared, or because actual gains might be considered too low to compensate for the transaction costs of negotiating an international agreement on it (to overcome the barrier created by difference in language or nomenclature).

¹³ This is very similar to the discussion on cooperation on international standards. See, for instance, W. Mattli, and T. Buthe, ‘Setting International Standards: Technological Rationality or Primacy of Power?’, (World Politics 56.1, 2003), p. 9-10.

system would then be required to allow for (a) changes in classification of old products; (b) inclusion of new classification for old and new products; (c) inclusion of new products in already existing classifications.

Along with that, according to the literature on coordination games, international law intended to solve coordination issues should focus rather on “structures that facilitate bargaining” than on “strong mechanisms for surveillance and enforcement” (Martin, 1993, p.101).

We believe that the creation of the World Customs Organization (WCO) has tried to deal with all these general requirements. Firstly, it did not establish different rights to different classification groups. Second, it created a common nomenclature list that sets a minimum structure for conferring nomenclatures (heading and subheading as explained in section 1 above), but at the same time it offered enough flexibility for parties to unilaterally include subcategories or products, change products from one classification line to another, and to include new products in already existing classifications or in new ones. And third, it offered an environment focusing on negotiations (every member of the WCO has a seat at the “Harmonized System Committee”, which decides on the nomenclatures) rather than on enforcement (members have a relative broad flexibility to apply its rules, and decisions of its dispute settlement committee are not binding on parties).

While the first two characteristics comply with our definition of “descriptive classification”, the third one reveals its adequacy in dealing with pure coordination problems. This seems to have been properly addressed, at least roughly speaking, the problems we described in this section. However, as we will argue below (section 3.b), this scenario changes considerably if we analyze the classification system in connection to the international trade rules. In general terms, when using the HS system as a common reference for determining a product’s tariff, the GATT/WTO system causes a shift of the classification system from a purely descriptive to a normative system by, at least, two means: (i) it assigns preferential rights on certain classes of products over others, for instance, certain classification classes have higher tariffs than others¹⁴, or might be subjected to more rigid subsidy rules; and (ii) through the concept of like products, it limits the reassignment of products to different classifications. Whereas that might be a logical extension to the protection of the entitlements foreseen in the trade system, it can have negative impacts on the mechanism created to deal with pure coordination problems.

3.2. Normative Classification *or* the Collaborative Game of Classification

Despite its apparent neutrality, however, at the international trade level classification is very much used as a means to differentiate things for the purpose of attributing those different rights. This causes a shift from a pure coordination game to a collaboration one, as has happened to the classification game with the advent of the modern trade regime.

In trade law, the GATT assigns different levels of tariffs to different (lines) classes of products, and limits the ability of states to reclassify products from one nomenclature to the other. That is to say, that each nomenclature has now a defined and specific cost. These costs have been negotiated and form a general “balance” in the trade regime which limits a State’s payoff. As States can get a higher payoff if they change the balance in their favor (which they can do if they cheat, by raising tariffs were they agreed not to) the system works in such a way that rational actors would try

¹⁴ The tariff level of the same classification line can vary from country to country, i.e., coming back to our example in the introductory section, the importation of horses can be taxed by 2% in Country A and 10% in Country B. However, what should be noticed is that once Country A.

to reclassify imported products to more costly classifications – not because there has been any fundamental changes in the way the product is used, but simply because that would give them a higher payoff.

Table 3: Classification as a collaboration game

		B	
		C	D
A	C	7,7	2,10
	D	10,2	3,3

In this game, two states have a common classification system which prescribes prerogatives to certain classes of products over others. The initial level of prerogatives has been agreed upon in such a manner that if one state manages to reclassify one of its products (assuming that it would only reclassify if it would increase its own payoff), it would do so at the expenses of the other. As we will argue in this section, this is pretty much the case at the current trade regime, where classification and trade obligations are tied by the agreements of the WTO. Under such conditions, players have strong incentives to defect from the established equilibrium. In which case, mechanisms to foster cooperation should focus on maintaining the agreement by providing “extensive information” and increasing the shadow of the future (Martin, 1993, p. 96). Rules limiting the possibility of escapes and enforcing the previous equilibrium will play an important role.

To sum up the reasons for this shift in the classification system, we initially had a set of rules that allowed states to work on a descriptive classification, i.e., there were no prerogatives assigned to any of the nomenclatures they chose to compose the classification system. In that regard, classification was used as an instrument to overcome transaction costs caused by the lack of harmonization and states have no incentive to defect the final agreement. Once the nomenclatures are *linked to a binding tariff*, and *reclassification was restricted to allow for the maintenance of a negotiated payoff* (what in WTO law is named balance of concessions), the system offers defectors the chance to increase their final payoff if they successfully manage to cheat at the expenses of the other player. These two facts, therefore, cause a shift from the coordination game to a collaboration one, and we should take a closer look at them.

The first one, the fact that nomenclatures have been assigned a tariff, is at the core of the trade system as we understand it today. Tariffication of barriers and tariff reduction was the central strategy of negotiators to mutually grant market access. For the benefits of a common nomenclature system in overcoming transaction costs on products negotiations, it seems natural that policy makers used the nomenclatures of the HS system as a reference. However, in doing so, they also compromised the “purity” of the descriptive system, i.e., they assigned prerogatives to different nomenclatures, giving states an incentive to reclassify products from one class to another. As this would make the market access commitments not viable, the GATT negotiators had to, somehow, restrict the mobility of products between classifications. For instance, if France classified wine as, let’s say, aliment and agreed to tax is at X%, it should not be able to move wine to the classification of “alcoholic beverages” subjected to a tariff higher than X%. In other words, it was important to ensure that commitments were protected and could be enforced.

The negotiators of the GATT/WTO have found a twofold solution for that. They have elaborated a sophisticated dispute settlement system that, at least after the establishment of the

WTO, issues legally binding decisions and has a certain degree of capacity to enforce them¹⁵, and they have limited reclassification by establishing, or rather submitting them to certain principles of the trade system. This link was established by force of the principle of *non-discrimination of like products*, either discrimination *between* foreign products, or *against* foreign products, both expressly prohibited by the most favored nation and the national treatment clauses (respectively, article I and article III of the GATT), and also by the obligation to provide treatment *no less favorable* by the one foreseen in the schedule of concessions (article II of the GATT). We will discuss in more details how each of these links work and how they might affect the behavior of states in section 4.

For now what is important to retain is that the GATT transformed the coordination game of common classification into a collaboration game. As each product (represented by its classification) has now been assigned a specific tariff, and as tariffs are bound on those products, an easy solution for a policy maker that intends to promote certain industries that have been limited by the GATT is simply to say that determined products are not part of a certain classification anymore, which broadly speaking would change their tariffs. This implies that parties (i) now have a tool to defect from their trade obligations; and also (ii) have an incentive to defect, as they are no longer in a coordination game.

The picture gets even more complicated with the establishment of the WTO, and with the regulation of broader areas of state jurisdiction, such as subsidies, trade in agricultural goods, intellectual property, and technical regulations. The (private/state) net of interests over the classification that a product might assume grew more complex and is not anymore simply a question of better tariffs: governmental support in the form of subsidies or state aid, and intricate systems of technical regulations are now entirely dependent on whether a product lays in one or another nomenclature of the HS system. Understanding, therefore, how the WTO/WCO agreements influence the behavior of States in determining classification of new products, and also what are the rules of re-classification, seem to be at the core of the issues raised here.

In order to do so, we first have to better understand how states behave and why would they reclassify products. We intend to define the behavior of states towards classification as a collaboration game by using methodological individualism and rational choice, building on three main assumption: (i) there is only one key decision maker representing the State, the “policy maker”; (ii) this policy maker is self-interested, rational and reasonably far sighted; and (iii) the policy maker wants to be re-elected (this is broad enough to encompass many preferences, such as getting rich, powerful), for which they need support from general electorate and from Special Interest Groups (SIG) – his political function is a weighted average of general welfare (which normally brings votes) and SIG welfare (guaranteeing political support).¹⁶

¹⁵ The enforcement of WTO rules is a topic of its own, but we will assume it to be enforceable. This does not seem far from the truth, if in comparison to the dispute settlement system of the WCO, in which no legal obligation to comply exists.

¹⁶ For a more detailed analysis of these issues, see S. A. B. Schropp, ‘Trade Policy Flexibility and enforcement in the WTO’, (Cambridge, University Press, 2009, p. 134-143). This political decision rationale is close to what Baldwin described as “Politically realistic objective function”; see R. Baldwin, ‘Politically realistic objective functions and trade policy’, (Economic letters 24, 1987, p. 289).

Table 4: How do policy makers decide?

Political function
General welfare + SIG welfare

Every trade decision has an impact on general welfare, but also on wellbeing of SIGs. SIGs are interested in maximizing the welfare of their participants, and in trade they can be exporters, importing competing sectors, foreign exporters, labor unions, and environmental/civil liberty SIGs (Schropp, 2009, p.138). In general terms:

Table 5: What do SIGs want?

SIGs							
Pro protection		Pro export		General Electorate			
Subsidies	Trade protection	Export subsidies (Additional access)	Open markets (Cheapersourcing)	Cheaper Products	Efficient allocation	Employment	Higher wages

In order to properly understand the incentives of SIGs, we have now to get an overview of how the WCO/WTO agreements might affect these general interests. As we argued above (section 3.a), if the WCO rules on “descriptive classification” are analyzed in isolation, we are dealing with a coordination game and SIGs will show no preference for one classification over the other. Their main interest here is to have a common language of classification, which supposedly brings them gains by reducing information costs. Once the GATT is brought into light, policy makers assign, by negotiation, a tariff to each of the classification lines, establishing an overall negotiated balance. However, policy makers will suffer pressure from SIGs to reclassify products – the pressure is actually to raise or lower tariffs, but as this has been prohibited by the GATT, SIG’s will put pressure on alternative instruments, such as reclassification. Pro protection SIGs, for instance, will lobby for placing imported products in classification lines with higher tariff duties. At this point, it still does not make sense for SIGs to lobby to have a domestically produced good placed in a different category. The main reason for that being the fact that national customs of an importing country will apply the tariff based on their own classification and not on the classification of the exporting country (and also that domestic subsidies were not seriously regulated).

Table 6: SIG’s Lobby under GATT

GATT
Tariffs (Both industry and agriculture)
SIGs will lobby over tariff by trying to reclassify importing competing products to higher tariffs nomenclatures.

With the advent of the WTO the figure gets more complex. The basic dispute over tariffs remains, but the regulation of subsidies, especially because of the distinction between industrial and

agricultural subsidies, raises the defection payoffs for SIGs, making non-compliance even more attractive than before.

Table 7: SIG's Lobby under the WTO

WTO			
Industrial		Agriculture	
Tariffs	Subsidies	Subsidies	Tariffs
Depend on the member's schedule, but are on average much lower than the ones on agriculture products.	Export and import substitution subsidies are prohibited; others have to be proven to cause specific effects.	Not as limited as those on industrial products. There are ceilings that have to be respected and also "green box subsidies" which are permitted.	Depend on the member's schedule, but are on average much higher than the ones on industrial products.
SIGs will lobby over subsidies trying to reclassify (or hold out) domestic products to agricultural nomenclatures SIGs will lobby over tariffs by trying to reclassify importing competing products to higher tariffs nomenclatures			

4. Implications and Possible Points of Stress

The core of the problem seems to lay on the fact that reclassification is, on the one hand, allowed by the WCO as an instrument to reduce transaction costs under a coordination game, and on the other, that it is very limited by the WTO. How these institutions deal with this problematic will not be fully analyzed in this paper, but some intuitions are that we should focus on the limits that the WTO imposes on reclassification, and also on dispute settlement system of both the WCO and the WTO.

4.1. Limits to Reclassification

The first restriction, the one based on like products, works as following: as a WTO member may not discriminate against/between like foreign products, and considering now that after the GATT each nomenclature has a tariff associated to it, one is to conclude that even if two like products have different nomenclatures they should present the same tariff level. This means that states might shift a like product from a lower tariff line to one with a greater tariff (which they are allowed to by the WCO – and nothing in the WTO agreements seem to prohibit them from simply shifting categories), but they will not be able to raise tariffs above the lowest one applied to a like product. In a sense, therefore, allowing for the shift would still preserve the "informational/descriptive" effect of the new classification, but could hinder opportunistic behavior from states that intended to use classification shifts as a means to avoid their GATT obligation. What we will often see, however, is a strong disagreement on whether products are or not alike. This entails a complex and case by case analysis by WTO panels and the Appellate Body. As we will

discuss later (section 4.b), certain characteristics of the WTO dispute system might conspire against this basic intuition that classification might not be used to circumscribe tariff obligations.

The second restriction is foreseen in GATT article II. By the obligation established in that article, States might not give to a product a treatment “less favorable” (such as higher duties) than the one negotiate and provided for in the schedule. The problem occurs when members shift one product from a nomenclature to another, let’s say LCD screens from TV components to computer components, for instance. If the new category allows for higher tariffs, can they be applied to the component?¹⁷ Do products carry their “duty” rights with them to other tariff lines¹⁸? If so, what are the impacts on transaction costs gains from common classification, on the market access commitments and on possible opportunistic behavior from States? These issues pose interesting legal questions that would require a deeper dogmatic analysis of the WTO law. In order to do so, the paper would have to address the current WTO jurisprudence and also the rules of interpretation of the HS system.

4.2. Institutional Design

We have argued that the WCO has been structured in such a way as to incentive states to classify in the most efficient way (it’s a classification market – whenever a demand for new classification occurs, the classification market will provide it – i.e., a State will offer that classification). This only happens because the system is correctly designed to address a coordination problem: it focuses on negotiations, it leaves great margin of flexibility for States, and it does not have the need for strong enforcement rules. However, as classification might, after the GATT, be used opportunistically, WCO now cannot simply allow for any reclassification to happen, as States have incentives to provide not for a “rational choice” classification, but rather for a “public choice” one, responding to domestic lobbies. Whether the WCO should be strengthened, or whether the WTO dispute settlement satisfactorily address both issues of trade and of the objectives of classification, should be better addressed in the future research.

5. Future Research Agenda

We have argued that the WCO has been structured in such a way as to incentive states to classify in the most efficient way (it’s a classification market – whenever a demand for new classification occurs, the classification market will provide it – i.e., a State will offer that classification). This only happens because the system is correctly designed to address a coordination problem: it focuses on negotiations, it leaves great margin of flexibility for States, and it does not have the need for strong enforcement rules. However, as classification might, after the GATT, be used opportunistically, WCO now cannot simply allow for any reclassification to happen, as States have incentives to provide not for a “rational choice” classification, but rather for a “public choice” one, responding to domestic lobbies.

In section 3.b we defined that state behavior is determined by a function that include the welfare of SIGs. Nevertheless, due to the trade negotiations, a certain level of payoffs has already been established by the GATT/WTO, and moving away from this level without compensating

¹⁷ Even if the new line has an applied duty that is lower than the former one, but has a higher bound tariff, a question of whether the shift was possible in the first place, still remains.

¹⁸ In addition to this, we could ask: would it matter if they are like products?

other countries is considered by the system to be unacceptable. This would mean that reclassification has now to be controlled, both at the trade level, as in the more technical level. This poses a problem to the WCO, whose technical decisions are not enforceable. That is to say that if a state is not behaving accordingly to the technical rules of classification (which it would not do in the absence of the GATT), the WCO has no power to push it to do it, which undermines the objective of the classification system, i.e., reducing TCs by providing a common language.

The future research on this topic will have to deeply address the issue of reclassification and the relation between the WCO and the WTO. We believe that there must be a cleared definition of what legitimate and opportunistic behavior are in terms of classification. Changing a product from a classification line to another might as well be result of a technological advance and might also contribute to improving predictability and stability of a common language system that reduces transaction costs in trade. Ensuring such reclassifications should be the goal of the WCO.

6. Conclusions

The GATT transformed the coordination game of common classification into a collaboration game. As each product (represented by its classification) has now been assigned a specific tariff, and as tariffs are bound on those products, an easy solution for a policy maker that intends to promote certain industries that have been limited by the GATT is simply to say that determined products are not part of a certain classification anymore, which broadly speaking would change their tariffs. This implies that parties (i) now have a tool to defect from their trade obligations; and also (ii) have an incentive to defect, as they are no longer in a coordination game. However, the WCO system has been structured to deal with coordination problems, and does not seem to have the tools to cope with collaboration issues (which focus on enforcement). The WTO, on the other hand, is mainly concerned with maintaining the level of commitments that has been agreed, and might ignore cases that would actually lead to a better (more efficient) classification of products.

Whether the WTO enforcement system, or the WCO has conditions to deal with the problem is still an opened question, and the intuition so far is that they do so in an unsatisfactory way. Final results, however, will depend on the analysis of former cases brought to the WTO and to the WCO.

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