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## Canada – Dairy

### Canada – Measures Affecting the Importation of Dairy Products and the Exportation of Milk\*

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#### 1 Introduction

This paper summarizes and critically reviews the dispute brought before the World Trade Organization (WTO) concerning *Canada – Measures Affecting the Importation of Dairy Products and the Exportation of Milk*, euphemistically referred to herein as *Canada – Dairy*. This dispute is centered on the WTO Agricultural Agreement, though it also involves the WTO Subsidies and Countervailing Measures (SCM) Agreement and GATT – 1994.

Many analysts have argued that a significant accomplishment of the Uruguay Round of negotiations was the development of a set of rules on agricultural supports, that covered the three main policy instruments of such support: border measures, domestic supports, and export subsidies. The national commitments made as part of the Agreement on Agriculture clearly represented just the beginning of agricultural reform, reflected by the fact that agriculture was earmarked as part of the built-in agenda going forward. It is widely recognized that the agricultural sector is one of the most highly subsidized sectors in the world. Liberalization of trade in agriculture was deemed the “linchpin” of the Uruguay Round for the United States and a number of other jurisdictions. It remains controversial today. Hence, this political and economic backdrop adds a special importance to this dispute.

\* This study has benefited from the suggestions of seminar participants at the Conference on the Principles of Trade Law: The World Trade Organization, held on February 6–7, 2003 in Philadelphia, and especially from the comments of Steve Charnovitz, William Davey, Wilfred Ethier, Henrik Horn, Robert Howse, Petros C. Mavroidis, David Palmeter, and John Ragosta. We are particularly indebted to Robert Hudec for extensive comments on earlier drafts of this study.

Contextually the dispute is also significant because it brings to light the systemic question of whether the Agriculture Agreement and the SCM Agreement are structured and drafted to strike the proper balance among the support measures, especially when there are spillover consequences of domestic support measures on export markets. Although the domestic price-setting mechanism is a distinct instrument from the export-pricing instrument, these instruments cannot be evaluated in isolation. Hence, in an environment of regulated prices and other domestic support measures, distortions introduced in one area (e.g. domestic supports) may have an impact on prices in another area, even if somewhat less regulated (e.g. export prices).

From a legal perspective, an important systemic feature of the case has to do with the relationship between the SCM Agreement and the Agriculture Agreement. The question of how the SCM Agreement should inform the Agriculture Agreement was raised but not answered in this dispute.

The discussion that follows undertakes a three-step analysis. In each step, we begin with the most general and turn in sequence to the more specific legal and economic issues raised by the *Canada – Dairy* dispute.

First, we consider the economic basis for the WTO provisions that are at the heart of this dispute. We ask: What are the underlying goals of the various WTO provisions touched upon in the *Canada – Dairy* case, and are the goals themselves sensible from an economic perspective?

Second, we present and evaluate the key factual and legal elements of the case, focusing primarily on the legal issues raised by the case in its final disposition (e.g. whether at the Panel or the Appellate Body level) that seem particularly important to understanding the stated legal and economic logic of the case. More specifically we ask: Have the reviewing panels and the AB applied the law consistently, mindful of WTO precedent? Are the panelists and the AB doing what they state they are doing? Are the judgments well grounded in legal argument? Is there ambiguity in the applicable law, as drafted? If so, how is it resolved – e.g. with deference to national measures, or through judicial license?

And third, we consider and evaluate the particular legal and economic issues and methodologies raised by the dispute. More specifically we ask: In light of the underlying goals of the relevant WTO provisions, was the resolution of the substantive economic issues around which the case revolved based on sound economic principles?

## 2 General economic analysis

The *Canada – Dairy* case raises several levels of questions from an economic perspective. A first-level question is: What are the goals of the various WTO provisions touched upon in this case, and are the goals themselves sensible from an economic perspective? This is the question that we review in this section. A second-level question is: In light of these goals, and taking them as given, was the resolution of the substantive economic issues around which the case revolved based on sound economic principles? This second-level question will be taken up in section 4, after the legal aspects of the case have been presented and evaluated in section 3.

What, then, are the goals of the various WTO provisions touched upon in this case? This case centers on the question of whether Canada's milk support schemes violated its export-subsidy-reduction commitments under Articles 3.3, 9, and 10 of Agriculture Agreement. Hence, we evaluate in this section the general economic basis for international commitments to reduce export subsidies on agricultural products such as those embodied in these Articles.

As a general matter, it is instructive to begin by considering the stated rationale for limiting export subsidies generally as contained in paragraph 2, section B of Article XVI GATT: "The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement." From an economic perspective, what is interesting about this statement is its assertion that export subsidies may have harmful effects for *both importing and exporting* governments.

By contrast, the Preamble of the Agreement on Agriculture and the Articles themselves suggest a more nuanced view of the impacts of agricultural export subsidies on importing and exporting governments. For instance, the Preamble lists as one of the four areas for achieving binding commitments the area of "export competition," and indeed Article 8 of the Agreement is entitled "Export Competition Commitments." This suggests that the commitments to reduce agricultural export subsidies are seen by WTO members as primarily serving the interests of competing exporters of agricultural products, but not necessarily the interests of importing governments. This suggestion is made more explicit in the last paragraph of the Preamble, which states: "... and taking into account the

possible negative effects of the implementation of the reform programme on least-developed and net food-importing developing countries.”

In fact, it might be said that the Preamble of the Agriculture Agreement reflects an underlying tension of interests between exporting and importing governments on the issue of export subsidies that is absent in the stance against export subsidies taken in the name of exporters and importers in section B of Article XVI GATT. As we explain below, tension between exporting and importing governments over the issue of export subsidies is more readily understood with standard economic arguments than is a unanimous stance against export subsidies. However, as we also explain below, standard economic analysis does not help us explain the way in which the tension between exporting and importing governments was resolved in the Agriculture Agreement. Thus, though for somewhat different reasons, the goals of the export subsidy provisions in both the Agricultural Agreement and section B of Article XVI GATT (and by implication, Article 3.1(a) of the SCM Agreement) are puzzling from an economic perspective.

### *2.1 The economic puzzle of international agreements to limit export subsidies*

To appreciate the economic puzzle posed by international agreements to limit export subsidies, let us begin by trying to explain with standard economic arguments the interests of exporting and importing governments as expressed in Part B of Article XVI GATT. To this end, consider a hypothetical world in which export subsidies were not prohibited and where no government had yet bound a tariff in a GATT negotiation. We might think of this hypothetical world as approximating in very broad terms the world as it might have existed during the early years of GATT, had Part B of Article XVI GATT not been introduced.<sup>1</sup>

In this hypothetical world, with governments then free to respond to an export subsidy with tariffs and/or export subsidies of their own, it can be generally shown that one country's export subsidy must be seen as harmful to the governments of competing exporting countries, but *beneficial* to the governments of importing countries (we explain this benefit below).<sup>2</sup>

<sup>1</sup> Part B of Article XVI GATT was introduced during the 1955 Review Session. We do not mean to suggest that there were in fact no tariff bindings in 1955, but only that at the time Part B of Article XVI GATT was introduced the tariff choices of most GATT Contracting Parties remained largely unrestrained by existing GATT tariff bindings.

<sup>2</sup> See Bagwell and Staiger (2002), chapter 10.

Hence, the position evidently taken by importing governments in the drafting of Article XVI GATT section B is not easily interpreted with standard economic arguments.

Perhaps surprisingly, the difficulty in making sense of the position taken by importing governments in Article XVI GATT section B cannot be overcome by allowing that real-world governments seem often to be driven more by special-interest politics than economics. Intuitively, the reason that an export subsidy could not be harmful to an importing government even in this setting is that, regardless of its underlying objectives, the importing government could always respond to an export subsidy by raising its import tariff so as to prevent the extra export volume from crossing its borders – thereby preventing any “disturbance” in the domestic economy – and simply collect more tariff revenue. If the importing government chooses not to “countervail” the export subsidy in this way, it is presumably because it has found a response that it likes even better. Either way, the importing government is guaranteed to gain.

Figure 10.1 illustrates. Let us consider a country that imports good  $y$ . In the right-hand quadrant of figure 10.1, the price of good  $y$  is measured on the vertical axis while the quantity of good  $y$  is measured on the horizontal axis. The downward sloping curve labeled  $M(p)$  depicts the domestic country’s import demand for good  $y$  as a function of the price,  $p$ , paid by importers of good  $y$  and prevailing for sales of good  $y$  in the domestic economy. The horizontal line labeled  $E_0^*(p^*)$  depicts the export supply of good  $y$  from the foreign country as a function of the price,  $p^*$ , received by foreign exporters and in the absence of a foreign export subsidy.<sup>3</sup> Imposing an import tariff  $t$ , the domestic country imports the quantity  $m_0$ , foreign exporters receive the price  $p_0^*$ , and the price of good  $y$  prevailing in the domestic economy behind the tariff wall is  $p_0$ . These magnitudes are each depicted in the right-hand quadrant of figure 10.1.

In the left-hand quadrant of figure 10.1, the price of good  $y$  is again measured on the vertical axis while the quantity of good  $y$  is measured on the horizontal axis, but the left-hand quadrant of figure 10.1 depicts the underlying demand and supply curves for good  $y$  in the domestic economy. The domestic demand curve is labeled  $D(p)$ , and as reflected

<sup>3</sup> The horizontal foreign export supply curve reflects the simplifying assumption that the domestic country is “small” on world markets. This assumption simplifies the exposition, but is inessential to the point being made.

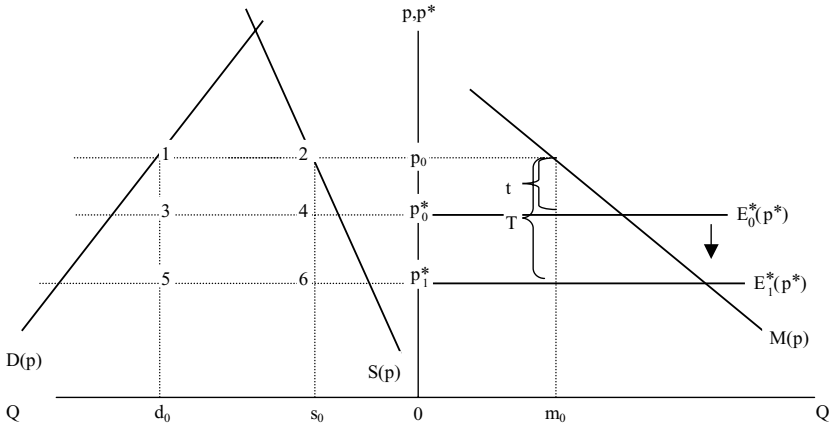


Figure 10.1

in the left-hand quadrant of figure 10.1, the quantity of good  $y$  demanded in the domestic economy is decreasing in the domestic price of good  $y$ . The domestic supply curve is labeled  $S(p)$  and, as reflected in the left-hand quadrant of figure 10.1, the quantity of good  $y$  supplied by domestic producers is increasing in the domestic price of good  $y$ . At the price  $p_0$  prevailing in the domestic economy, the quantity demanded in the domestic country is depicted as  $d_0$ , while the quantity supplied by domestic producers is depicted as  $s_0$ . The difference between  $d_0$  and  $s_0$  is the import quantity  $m_0$ , and the box labeled 1342 depicts the tariff revenue collected under the tariff  $t$ .

Now suppose that the foreign government applies an export subsidy to good  $y$ . In the right-hand quadrant of figure 10.1, this will shift the foreign export supply curve down, lowering the price at which foreign exports of good  $y$  are available to the domestic country. In the right-hand quadrant of figure 10.1, this lower price is labeled  $p_1^*$ , and the foreign export supply curve in the presence of the foreign export subsidy is labeled  $E_1^*(p^*)$ . If the domestic government responds to the foreign export subsidy with an increase in the tariff above  $t$ , it can maintain at the level  $p_0$  the price of good  $y$  that prevails in the domestic economy behind the tariff wall. In the right-hand quadrant of figure 10.1, the tariff that achieves this domestic price preservation is labeled  $T$ .

The left-hand quadrant of figure 10.1 then depicts the impact on the domestic economy of the foreign-export-subsidy-cum-domestic-tariff-response just described. By design, the tariff  $T$  preserves the domestic

price level  $p_0$ , and so neither the quantity demanded  $d_0$  nor the quantity supplied  $s_0$  in the domestic economy is altered. The only change experienced in the domestic economy is an increase in tariff revenue collected from the (unchanged) import volume  $m_0$ . The tariff revenue collected by the domestic government grows from the original box 1342 to the new larger box 1562 depicted in the left-hand quadrant, with the increased tariff revenue then corresponding to the box 3564.

Hence, as figure 10.1 makes clear, whatever the underlying objectives that might motivate a government to intervene with an import tariff, it can only benefit from the introduction of a foreign export subsidy, *provided it is free to make adjustments to its tariff*. This is because, as figure 10.1 depicts, the importing government can always continue to maintain the same domestic price level and import volume behind an extended tariff wall, and simply collect more tariff revenue.

For export subsidies to actually harm an importing government, standard economic arguments indicate that this importing government would have to (a) be concerned about the injury to domestic producers caused by the increased foreign exports resulting from the foreign export subsidy, *and* (b) lack the ability to use tariffs (or other policy instruments) to respond to this injury. Common-sense explanations of why export subsidies are harmful to importing governments often emphasize (a) without acknowledging that (b) is also required. But if (b) were emphasized as well, the position that importing governments are hurt by export subsidies might be taken less as an article of faith. Instead, whether or not an importing government considers export subsidies harmful to it would depend on the particular circumstances of the importing economy, and specifically on the degree of freedom that the importing government had to respond to the export subsidy with its tariff policy.

Of course, with the creation of GATT, governments surely anticipated that they would bind the majority of their tariffs through subsequent negotiation, and so perhaps this anticipation explains the position that export subsidies are expected to be harmful to importing governments. But within the GATT/WTO, the freedom arguably still exists to respond to an export subsidy with an increased tariff even after tariffs are bound. For example, an importing government has the freedom to respond to an export subsidy by imposing a countervailing duty under GATT Article VI (which would require no compensation and would be a discriminatory tariff action) or by renegotiating its tariff level under GATT Article XXVIII (which would involve compensation and would be a non-discriminatory tariff action). To the extent that these avenues of response are viable,

standard economic arguments imply that agreements that attempt to place limits on export subsidies are not serving the interests of importing governments.

It is true that in practice, due to a variety of possible “transaction costs,” these escapes may indeed be quite costly to use, and the resulting inflexibility of tariff commitments might then serve as the basis for understanding why export subsidies could be viewed as harmful by the governments of importing countries who had bound their tariffs. At a general level, this observation would seem to suggest a promising direction for further consideration of the degree to which the conclusions of the standard economic arguments reviewed above are robust. But the economics literature has yet to develop a formal treatment of the transaction-cost position in this context.

Hence, we may articulate a first piece of the economic puzzle posed by international agreements to limit export subsidies: standard economic arguments predict a tension between the interests of exporter governments and importer governments in this context, and so these arguments cannot account for the mutuality of interests expressed by exporting and importing governments in Part B of Article XVI GATT.

As we observed above, while the tension between the interests of exporter governments and importer governments that is predicted by standard economic arguments is absent from Part B of Article XVI GATT, this tension can be seen in the Preamble of the Agriculture Agreement. Nevertheless, it would be wrong to conclude from this observation that the export subsidy provisions of the Agriculture Agreement can find support from standard economic arguments. This is because, if followed to their logical conclusion, the standard economic arguments carry with them an even more provocative implication about the way in which this tension should be resolved. This is the second piece of the economic puzzle posed by international agreements to limit export subsidies: from a worldwide perspective, governments that choose to subsidize their exporters in the absence of international agreements should be encouraged to subsidize *more* under international agreements, not less.

The essential reason for this provocative implication of standard economic arguments is that, when the impacts on both competing exporter and importing governments are taken into account, an export subsidy can always be shown to confer a net benefit on the rest of the world. Through an international agreement, this net benefit can be “internalized” by the grantor of the export subsidy, resulting in an expansion of its export-subsidy program.



Why is it that an export subsidy can always be shown to confer a net benefit on the rest of the world? We may gain an intuitive understanding of this fact by returning to figure 10.1 above. Let us suppose that the foreign export supply of good  $y$  actually comes from two foreign countries, foreign country 1 and foreign country 2, whose exporters of good  $y$  are competing for sales in the domestic-country market. In the right-hand quadrant of figure 10.1, the horizontal line labeled  $E_0^*(p^*)$  then depicts the total export supply of good  $y$  from the foreign countries 1 and 2 as a function of the price,  $p^*$ , received by foreign exporters and in the absence of a foreign export subsidy.

Now suppose that foreign country 1 applies an export subsidy to good  $y$ . Suppose further that, in response to the export subsidy of foreign country 1, foreign country 2 introduces an export subsidy of its own that permits its exporters to continue to export the original volume of good  $y$  to the domestic country and receive (inclusive of its export subsidy payment to them) the original price for their export sales. Notice that, under this response, the entire impact on foreign country 2 of foreign country 1's decision to offer an export subsidy is reduced to the *budgetary cost* of foreign country 2's export subsidy program, since under this export-subsidy program foreign country 2's exporters are completely insulated from any effects of foreign country 1's export subsidy. Suppose, then, that the upshot of foreign country 1's export subsidy and foreign country 2's described response is reflected in the right-hand quadrant of figure 10.1 by the downward shift of the foreign export supply curve to that labeled  $E_1^*(p^*)$ .

Figure 10.1 may now be used to develop an intuitive understanding of why an export subsidy can always be shown to confer a net benefit on the rest of the world. In the case under consideration, we may ask: How is it that we can be sure that foreign country 1's export subsidy confers a net benefit on the domestic importing country and the competing exporter foreign country 2? We can be sure of this fact for a simple reason: the extra tariff revenue collected by the domestic country under the tariff  $T$  in the presence of the foreign export subsidies, labeled as the box 3564 in the left-hand quadrant of figure 10.1, is more than sufficient to pay for the budgetary cost of foreign country 2's described export subsidy program.<sup>4</sup>

<sup>4</sup> This can be seen with the aid of figure 10.1 by observing that foreign country 2's described export subsidy must be at a (per-sales-unit) level which equals the difference between the original price received by foreign exporters,  $p_0^*$ , and the new price received by foreign exporters (excluding their subsidy receipts),  $p_1^*$ . This difference is the height of the box 3564 in the left-hand quadrant of figure 10.1. For foreign country 2, the budgetary cost

Hence, it follows that the domestic importing government could fully compensate foreign country 2 for the harm done to it by foreign country 1's export subsidy (i.e. the domestic importing government could pay for the budgetary cost of foreign country 2's described export-subsidy program) and still enjoy some remainder of the box 3564 for itself.<sup>5</sup>

For the reasons described above, it is difficult to utilize standard economic reasoning to offer broad support for worldwide benefits from export subsidy provisions which seek to place limits on export subsidies such as those touched upon in the *Canada – Dairy* case. Instead, standard economic reasoning leads to the conclusion that negotiated commitments to reduce the level of export subsidies from their unilateral levels represent an inefficient victory of exporter interests over importing – and world – welfare. The bottom line, then, is that the standard economic perspective does not provide broad support for the position that facilitating agreements to restrain export subsidies is an activity that the WTO should be involved in.<sup>6</sup>

## 2.2 *What is wrong with the standard argument against export subsidies?*

At this point it would be reasonable to ask: What is wrong with the standard argument against export subsidies? After all, standard economic arguments imply that free trade is the efficient outcome for the world, and that international agreements that reduce the level of intervention toward free trade – such as those that reduce export subsidies – are therefore efficiency-enhancing. Why do these standard arguments not provide formal support for the position that international agreements to limit export subsidies make economic sense?

of its described export-subsidy program is then this per-sales-unit export subsidy level multiplied by the total export volume of its good-*y*-exporting firms. But the total export volume of foreign country 2's good-*y*-exporting firms must be less than  $m_0 = d_0 - s_0$  in figure 10.1, because foreign country 1's exporters are also supplying a portion of the trade volume  $m_0$ . As  $d_0 - s_0$  is the length of the box 3564, it then follows that the box 3564 is larger than the budgetary cost of foreign country 2's described export subsidy program.

<sup>5</sup> As before, if in the present case under discussion the importing government or the competing exporter government chooses not to respond to the export subsidy of foreign country 1 in the described fashion, then it is presumably because an even better response has been found. Either way, the two governments can always be assured of a net benefit from foreign country 1's export subsidy.

<sup>6</sup> See Bagwell and Staiger (2002), chapter 10. This conclusion follows provided that the goal of the WTO is to serve the interests of its member governments, and that those interests are represented at the WTO bargaining table.

The difficulty with this position is that the formal conditions that are necessary to make free trade efficient when the interests of all governments are accounted for rule out the possibility that these governments would also choose to subsidize exports in a unilateral policy setting. In fact, such formal models predict that governments would *tax* exports in the absence of an international agreement, and hence a negotiated movement to free trade, while efficiency-enhancing in these models implies an international agreement that eliminates export taxes and thereby expands trade volumes.

Once these formal models are augmented with ingredients – such as political economy considerations or imperfect competition – that are capable of converting the predicted government policy choices from export taxes to export subsidies, the augmented models themselves no longer imply that free trade is efficient when the interests of all governments are accounted for (see also note 6). Efficiency continues to require international agreements that expand trade volumes from the levels implied by unilateral policy choices in these augmented models, but this is now accomplished in these augmented models by international agreements to increase export subsidies.

As a consequence, the contention that agreements to reduce export subsidies serve the interests of WTO Member governments because they represent a movement away from policy intervention and toward free trade does not stand up to formal scrutiny.<sup>7</sup> We are thus left with the bottom line that formed the concluding observation of the previous sub-section: the standard economic perspective does not provide broad support for the position that facilitating agreements to restrain export subsidies is an activity that the WTO should be involved in.

### 2.3 *Interpretation 1: rethink economic explanations of export subsidy agreements*

This observation invites at least two possible interpretations. A first interpretation emphasizes the limits of existing formal economic reasoning in this instance, and casts doubts on the ability of existing formal economic

<sup>7</sup> It is also interesting to observe that current efforts in the developed world to further restrict export subsidies in agriculture so as to help developing countries are driven by the interests of developing countries who are themselves competing exporters of agricultural products. The economic perspective outlined above would nevertheless predict that food-importing developing countries, food-importing countries more generally, and the world as a whole stand to lose if these efforts are successful.

models to adequately capture the role that international agreements to limit export subsidies can play. According to this interpretation, it is important to seek and develop further alternative modeling approaches that might better reflect some critical feature associated with the issue of export subsidies that the standard models have failed to capture. We have already mentioned the possibly important role of transaction costs in this regard. It is also possible that modeling approaches which see international agreements as helping governments make commitments to their own private sectors – rather than to other governments – may point the way to a more complete understanding of the role that international agreements to limit export subsidies can play.<sup>8</sup>

In the case of agricultural markets, the notion that governments might seek international agreements as a way to make commitments to their own private sectors – that is, to “tie their own hands” against intervention in the face of otherwise irresistible pressure from strong special interests – has a special appeal. Intuition would suggest that, given the extreme domestic political forces at work in agricultural markets, national governments might well seek ways to stand up to these pressures, and international agreements are a likely tool in this regard. Indeed, at a general level there is some empirical evidence that GATT/WTO commitments do play this role.<sup>9</sup>

Nevertheless, it is important to point out that, as yet, there is little formal understanding of the way in which international commitments might actually work toward this purpose. And there is even less formal understanding of the way that such international commitments might be structured to serve this purpose more effectively. A greater formal understanding of these issues could yield important dividends.

As one illustrative example, if governments seek to “tie their own hands” when it comes to resisting political pressures over domestic agricultural policies, then the ability to make commitments that afford very little discretion or ex-post flexibility can be very valuable in serving this purpose.<sup>10</sup> But when it comes to international commitments, the realities of international enforcement may call for a fairly high degree of flexibility in these commitments.<sup>11</sup> From this perspective, provisions of the Agriculture Agreement that give a government ex-post flexibility to “untie its hands,” such as the special safeguard provisions contained in Article 5, would work

<sup>8</sup> For a recent review of the commitment approach to the study of trade agreements, see Bagwell and Staiger (2002), chapter 2.

<sup>9</sup> See Staiger and Tabellini (1999). <sup>10</sup> See Staiger and Tabellini (1987).

<sup>11</sup> See Bagwell and Staiger (1990).

against the purpose of “hand tying,” but may reflect a pragmatic position on the limits of international enforcement. This perspective might then in turn suggest that the flexibility afforded to governments under Article 5 could be further restricted – and the “hand-tying” purpose of the Agreement thereby better served – if the WTO dispute settlement procedures as they apply to the Agriculture Agreement were further enhanced.

In any event, under this first interpretation, while the way in which international agreements over export subsidies should be understood from an economic perspective is still an open question, and while the most effective design of these agreements may therefore still be an open question as well, the wisdom of GATT/WTO efforts to restrain the use of export subsidies is not really in doubt.

#### *2.4 Interpretation 2: rethink WTO efforts to limit export subsidies*

A second interpretation would place more weight on the presumptions implied by the standard economic arguments reviewed above, and this second interpretation casts doubts on the rationale for international agreements to limit export subsidies.

While this second interpretation may seem far-fetched and thus easily dismissed by those familiar with the GATT/WTO’s long history of attempts to restrain export subsidies, it actually reflects a logic that is familiar in other settings. An intuitive appreciation of this logic can be gained by considering a simple analogy from the study of domestic anti-trust policy.

Let us consider a single market, and suppose there are a small number of “big” sellers and “big” buyers in this market.<sup>12</sup> Due to the small numbers, each seller realizes that its sales will have an impact on the market-clearing price, and so each seller will tend to restrain its supply somewhat so as to raise the market-clearing price. That is, on the sellers’ side, we have an oligopoly situation, in which the quantity supplied by the industry will tend to be lower than the efficient competitive level. Likewise, due to the small numbers, each buyer realizes that its purchases will have an impact on the market-clearing price, and so each buyer will tend to restrain its demand somewhat so as to lower the market-clearing price. That is, on the buyers’ side, we have an oligopsony situation, in which

<sup>12</sup> Implicitly, the description that follows assumes that demand in this market is characterized by a small number of big buyers that coexist with a “competitive fringe” of additional small buyers. Since the existence of this competitive fringe is important only for technical reasons, we highlight in the text only the role of the big buyers.

the quantity demanded by the industry will tend to be lower than the efficient competitive level. The upshot is that, at the resulting market-clearing price, this market will have fewer sales – that is, less trade volume between buyers and sellers – than is efficient from the perspective of both the buyers and the sellers in total.

Consider now two possibilities for negotiation among the players in this market. A first possibility is that both buyers and sellers sit down at the negotiating table. A second possibility is that only the sellers meet to negotiate.

Under the first possibility for negotiation, both buyers and sellers can gain relative to their initial positions if each buyer agrees to increase its demand and each seller agrees to increase its supply in a “reciprocal” fashion, so that the original market-clearing price is preserved. To see how such an agreement can be beneficial to both buyers and sellers, recall that their initial positions reflect an inefficient situation in which there is too little trade between them at the market-clearing price. But the reciprocal agreement just described would induce a greater volume of trade without changing the market-clearing price. Hence, by agreeing to expand trade in this reciprocal fashion, buyers and sellers can together reduce the inefficiency and thereby each share in the resulting gains. In fact, it can be shown that achieving greater trade volume will be a necessary condition for all parties to gain from the negotiation in this situation. And as negotiations are voluntary, it may be expected that each party to the negotiation does indeed gain.

We may conclude that trade-volume-expanding agreements are needed to solve the inefficiency in this situation, and that negotiations that involve both buyers and sellers are therefore likely to result in efficiency-enhancing volume-expanding agreements.

Under the second possibility for negotiation, only the sellers are present at the negotiating table. Now it is no longer possible to negotiate an expansion of trade volume that preserves the original market-clearing price, because to do so would require reciprocal commitments on both sides of the market (i.e. by both sellers and buyers). The sellers can still gain from their negotiations, though, but to do so they must agree to *restrict* trade, not expand it, and thereby jointly raise the market-clearing price. In effect, as every student of anti-trust policy is taught, if oligopoly suppliers are allowed to cooperate through mutual agreements, they will combine to restrict trade. Such an agreement is beneficial to the suppliers, as it moves their joint supply decisions closer to the monopoly outcome, but it is bad for buyers and for overall efficiency when the interests of both

sellers and buyers are counted, because it moves joint supply farther from the competitive outcome.

We may conclude that, while trade-volume-expanding agreements are still needed to solve the inefficiency in this situation, negotiations that involve only sellers are likely to result in restrictions in trade and further worldwide inefficiency.

What does this have to do with the WTO and its export-subsidy provisions? We may think of typical market-access negotiations within the GATT/WTO as corresponding to the situation in which both the buyers and the sellers are themselves each small players in a competitive market, but are represented at the international bargaining table by their respective governments, who in turn have the ability to affect (world) market-clearing prices with their trade policy choices.<sup>13</sup>

In a typical situation, sellers of good 1 in country 1 seek access to buyers of good 1 in country 2, while sellers of good 2 in country 2 seek access to buyers of good 2 in country 1, and the governments of countries 1 and 2 then come together to negotiate an exchange of market access commitments. Importantly, in these negotiations the interests of both the sellers of goods 1 and 2 (represented by the governments of countries 1 and 2, respectively) and the buyers of goods 1 and 2 (represented by the governments of countries 2 and 1, respectively) are represented. As a consequence of this representation, the negotiated market-access agreements are naturally trade-expanding in their effect, taking the form of various commitments to policy changes that increase trade volumes from the levels implied by unilateral policy choices.<sup>14</sup>

In the same way, we may think of negotiations over export subsidies within the GATT/WTO as corresponding to the situation in which only sellers are represented.<sup>15</sup> As a consequence of this representation, the negotiated commitments are naturally trade-restricting in their effect, taking the form of various commitments to policy changes that reduce trade (export) volumes. From this vantage point, agreements by exporting

<sup>13</sup> In fact, while we develop this argument in the context of trading economies with perfectly competitive export sectors, an identical logic applies if instead the export industry is characterized as an oligopoly (see Bagwell and Staiger, 2002, chapter 10).

<sup>14</sup> Here the GATT/WTO negotiating norm of “reciprocity” can serve the role of fixing (world) market-clearing prices in the presence of negotiated increases in trade volumes (see Bagwell and Staiger, 2002, chapter 4), completing the analogy with the oligopoly/oligopsony negotiations discussed above.

<sup>15</sup> More accurately, those represented at the negotiating table are net sellers (i.e. exporters), and what is important is that the interests of the other side of the market, namely the net buyers (i.e. importers) are not being served by such negotiations.

governments to limit export subsidies can be interpreted as a “sellers’ combination in restraint of trade,” with the consequent implications for overall efficiency (i.e. good for the sellers, but not for the buyers, and not for the sellers and buyers on the whole).<sup>16</sup>

The simple point is that the standard economic rationale for the purpose of negotiations over trade policy is that trade volumes are inefficiently low when governments set their trade policies unilaterally. As a consequence, from this perspective, the central task of trade negotiations is to expand trade volumes beyond their unilateral levels to more efficient levels. Since agreements to restrict export subsidies are agreements to restrict trade volumes below unilateral levels, such agreements appear to run counter to efficiency. Any economic argument in support of international agreements to restrict export subsidies must overcome this basic dilemma.

### 3 Factual and legal claims

#### 3.1 Introduction and overview

In this dispute the United States and New Zealand challenged certain Canadian government domestic milk-production and export supports that were provided through Canada’s Special Milk Classes Scheme as well as the Canadian government’s application of its tariff rate quota for imports of fluid milk. The Canadian government has a comprehensive system of supply management for industrial milk that includes production quotas, administered price supports and border measures.

This dispute centered on allegations of excessive use of export subsidies and the Canadian government’s misuse of its tariff rate quota. However, more broadly this case arises out of the tensions between the instruments of supply management. Indeed, it may not be possible to understand the

<sup>16</sup> We observe that the same logic is at work on the import-policy side. If, for example, importers of a product come together to negotiate a customs union, then as they harmonize their external tariffs on the products they jointly import from outside the customs union, they will have an incentive to agree to external tariffs that more effectively exert their combined oligopsony power, which is to say they will have incentive to negotiate higher external tariffs that restrict external trade volume. This incentive is inefficient from the point of view of world (buyer and seller) welfare, and if the exporters of these products from outside the customs union were also represented in these negotiations, trade volumes would presumably not be restricted in this way. In some ways, the provisions of Article XXIV GATT that specifically prohibit raising external tariffs in this circumstance may serve to give exporters outside of the customs union some representation in these negotiations, and thereby contribute toward ensuring that inefficiencies do not arise from this incentive.



nature of this dispute – export subsidies – without examining the governmental interventions that have affected the relationship between export and domestic prices. Substantively, the case is important in part because of the balance that was struck when evaluating the relationship between domestic and export subsidies. In terms of the WTO-covered agreements, the dispute is important in its interpretation of the Agricultural Agreement.

From a legal point of view, the most significant interpretative judgments are contained in the rulings of the AB in its evaluation of the 21.5 panel findings on implementation of a revised Milk Classes Scheme. However, the discussion that follows takes us through all of the phases of this dispute.

The regulatory features and entities responsible for implementation and management of the Canadian dairy regime are complex, and will not be fully recounted here.<sup>17</sup> Suffice it to say that regulatory control over trade in dairy products is divided between federal and provincial governments, and there are three main entities that have decision-making roles with respect to the production and sale of milk in Canada:

- the Canadian Dairy Commission (CDC), which can establish national target prices and sell and buy dairy products and pool products;
- the provincial milk marketing boards, which regulate production and marketing in intraprovincial trade of dairy products, comprised “mostly or exclusively” of dairy producers; and
- the Canadian Milk Supply Management Committee (CMSMC), which is a federal–provincial agreement that regulates the marketing of milk and cream products in Canada.

The CMSMC, which is composed of representatives from the provincial market boards and provincial governments, oversees implementation of a comprehensive pooling scheme, which is the basis for the Special Milk Classes Scheme. The Boards develop an annual plan through the National Milk Marketing Plan, which develops an annual production target for industrial milk, which is called the Market Sharing Quota, allocated among the provinces, which in turn allocate targets to individual farmers.

The Special Milk Classes Scheme established five different classes, four of which are designed for the domestic market and the fifth which is comprised of a cluster of five sub-classes for “Special Milk.” A purpose of the Scheme was to fund the CDC’s losses in exporting surplus milk.

<sup>17</sup> See the Panel Report para. 2.1 to 2.66 for full details.

Class 5(d) is for milk used in products exported, notably for the US and UK markets under a negotiated quota system, and 5(e) is for removal of surplus milk from the domestic market, which can be in- or over-quota. Prices in the first four classes are developed by provincial marketing boards. Special Class 5, which is the class at issue in this dispute, requires processors and exporters to apply for a permit from the CDC. The permit is then used as the basis for gaining provincial access to the milk. Classes 5(a) through (c) provide permits on an annual basis while classes (d) and (e) require exporters/processors to negotiate prices with the CDC on a transaction-by-transaction basis.

Pricing differs by class.<sup>18</sup> Returns to producers are calculated on the basis of a system of pooling, separated between those that are in-quota and over-quota. In-quota sales are pooled regionally, while over-quota sales are more limited.

The complainants, the United States and New Zealand, challenged Special Classes 5(d) and 5(e) of the Special Milk Classes Scheme under Articles 9.1(a), 9.1(c) and 3.3 of the Agricultural Agreement, and in the alternative under Article 10.1 of this same agreement. They argued that Canada's scheme provided export subsidies within the meaning of Article 9 of the Agricultural Agreement which exceeded Canada's reduction commitments and therefore constituted a violation of Article 3 of the Agriculture Agreement. The US also challenged the Scheme under Article 3 of the SCM Agreement. And both the United States and New Zealand challenged Canada's application of its tariff rate quota for fluid milk.

To summarize the overall conclusion of the case: the Panel found that the Canadian Scheme represented a violation of Articles 9.1(a), 9.1(c), 3.3 and 10.1 of the Agriculture Agreement. Further, it held that some of the restrictions imposed by Canada under its tariff rate quota violated GATT Article II.1(b). These findings were appealed by Canada. The AB reversed on a number of elements. A "reasonable period of time" after the DSB ruling when implementation was expected to be complete, the complainants again challenged Canada for failure to bring its system into conformity with the DSB ruling. A reviewing panel on implementation was formed, hereinafter called the first 21.5 panel, which held that the revised scheme continued to provide export subsidies to the Canadian

<sup>18</sup> For example, (a) and (b) are by formula; (c) reflects a negotiation between the CMSMC and manufacturers; (d) and (e) are case-by-case negotiations between the CDC and exporters/processors.

industry. Canada appealed and the AB reversed in part. A second 21.5 Panel completed its evaluation pursuant to the AB ruling on the first 21.5 Panel report in July 2002. Again Canada appealed certain issues in the second 21.5 Panel report and the AB issued its report in December 2002.

The discussion that follows breaks this history into two parts: the first phase, including the Panel and AB ruling, and the second phase, which includes the rulings of the 21.5 Panels and the AB.

### 3.2 Phase I: the Panel and the AB report

*Article 9.1(a) of the Agreement on Agriculture:* The complainants argued that Classes 5(d) and (e) under the Scheme amount to export subsidies under Article 9.1(a) of the Agricultural Agreement, which obliges governments to reduce their direct export subsidies. This provision requires reductions of

[t]he provision by governments or their agencies of direct subsidies, including payments in kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance.

The Panel noted that under 9.1(a) an export subsidy comprised four different elements: (1) direct subsidies, including payments in kind (2) provided by governments or their agencies (3) to a firm, an industry, to producers of an agricultural cooperation or other association of producers, or to a marketing board and (4) which are contingent on export performance.<sup>19</sup>

The Panel examined the applicability of each of these elements in turn and concluded that the milk made available under Special Classes 5(d) and (e) constituted export subsidy subject to reduction commitments. Summarizing this discussion in brief, the Panel noted that since processors and exporters obtain the milk and the milk is made available for exports, the facts support elements three and four above.<sup>20</sup>

The question of whether these facts support a finding of direct subsidies, including payments in kind, stand at the heart of the legal controversy. The Panel noted that this connotes a “gratuitous act,” and that a payment connotes in turn the granting of a benefit. Payments in kind include the provision of a good free of charge or at less than the normal price.<sup>21</sup> Under the Scheme, the exporters and processors obtain the milk at less than the price

<sup>19</sup> See para. 7.38.

<sup>20</sup> See para. 7.39.

<sup>21</sup> See para. 7.43.

for use on the domestic market. Indeed, the milk prices available under Classes 5(d) and (e) were significantly lower than domestic prices or other prices and, given high tariffs on imports, they were also lower than the price of imported milk.<sup>22</sup> Hence, these facts and others led the Panel to conclude that the elements of “payment in kind/direct subsidy” as well as the “benefit” elements were met.

The remaining element was whether the payments were provided “by governments or their agencies.”<sup>23</sup> The Panel examined the character and operation of the Scheme and the role of the regulatory bodies. It emphasized the decision-making roles played by the CDC, which is a Crown corporation under the Federal Government of Canada, the role of provincial marketing boards and the CMSMC. Considering the role of government involvement in the Scheme, the Panel identified the CDC as the ultimate decision maker on the question of whether or not domestic requirements were met and whether milk constituted surplus for export, among other variables. Since all elements of 9.1(a) were present, the Panel held that Special Classes 5(d) and (e) milk amounted to an export subsidy that was subject to reduction commitments.

On appeal, the AB reversed on several of these elements. Specifically, it reversed on the availability of “direct subsidies” and “payments in kind” and therefore disagreed with the Panel’s conclusion that the measures constitute an inconsistency under the Agricultural Agreement Article 9.1(a).<sup>24</sup>

While arguing that the Panel properly looked to the SCM Agreement for guidance on the general definition of a subsidy contained in its Article 1.1, the AB argued that the Panel applied this definition improperly. The AB did not agree with the concept of “benefit” being equated with the term “payment in kind” given that the latter was simply a form of payment. It was theoretically possible to receive full consideration for a payment in kind thereby failing to meet the requirement of “benefit” or a gratuitous act.<sup>25</sup> Further, the AB argued that the Panel had also “failed entirely to make any mention of the other integral aspect of a subsidy under Article 1.1 of the SCM Agreement, namely the need for a financial contribution.” Having reached a different finding on the meaning of the terms “direct subsidies” and “payment in kind,” the AB therefore reversed the Panel’s conclusion that the Canadian measures involved export subsidies under Article 9.1(a).

<sup>22</sup> See para. 7.58.      <sup>23</sup> See para. 7.63.

<sup>24</sup> The AB did, however, concur with the Panel that the provincial milk marketing boards constituted “agencies of Canada’s Government” for purposes of Article 9.1(a).

<sup>25</sup> See paras. 87–91.

*Article 9.1 (c)*: The complainants also alleged that certain classes of milk under the Scheme were a violation of Article 9.1(c) of the Agriculture Agreement. This provision covers “payments on the export of an agricultural product that are financed by virtue of governmental action.”<sup>26</sup> The Panel interpreted the first part of this provision that requires that the payment is “conditional or contingent on exports” to be analogous to the finding of export conditionality under Article 9.1(a). The Panel also considered and answered in the affirmative that the term “payments in kind” is covered by the terminology of “payment” in 9.1(c).<sup>27</sup> Given the role of the provincial boards in paying milk producers a monthly income and the intermediary role of the boards, the financial function of governmental action was also deemed present. The Panel found that lower-priced milk provided to processors for export under the Scheme constituted a subsidy under Article 9.1(c) of the Agricultural Agreement. This issue was also appealed and the AB upheld the Panel findings.

*Article 3.3 of the Agricultural Agreement*: Article 3.3 is designed to prohibit export subsidies, as defined in Article 9.1, that exceed a Member’s commitment levels.<sup>28</sup> The Panel held that the actions were inconsistent with Article 3.3 given that the total quantity of exports generated through subsidies provided to classes 5(d) and (e) under the Scheme were clearly in excess of Canada’s quantity-reduction commitment levels identified in its Schedule.<sup>29</sup>

*Articles 10.1 and 8 of the Agriculture Agreement*: The Panel also concluded that the treatment of Classes 5(d) and (e) under the Scheme constituted a violation of Articles 10.1 and 8 of the Agriculture Agreement. Article 10.1 is an alternative basis for determining whether an export subsidy exists. It provides that “export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens or leads to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments.”<sup>30</sup> Focusing on the question of whether “other” export subsidies exist that are not listed in Article 9.1, the Panel looked particularly to 10.1(e) which “covers a wider range of export subsidies than the

<sup>26</sup> See para. 7.88.      <sup>27</sup> See para. 7.92.

<sup>28</sup> Specifically it states: “Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not provide export subsidies listed in paragraph 1 of Article 9 in respect of the agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not provide such subsidies in respect of any agricultural product not specified in that Section of its Schedule.”

<sup>29</sup> See para. 7.115.      <sup>30</sup> See para. 7.117.

specified practices listed in Article 9.1.” The Panel also looked to Article 1 of the SCM Agreement.<sup>31</sup>

Noting the arguments under 9.1(a) and (c), the Panel held that assuming in the alternative that the treatment of Classes 5(d) and (e) did not constitute an export subsidy as listed in 9.1(a) or (c), it would come under the “other” category of export subsidy for purposes of Article 10.1.<sup>32</sup> Since Article 8 requires Members “not to provide export subsidies otherwise in conformity with this Agreement,” the Panel held that Canada’s measures were inconsistent with Article 8.

The United States also claimed that Article 3 of the SCM Agreement was violated by virtue of the provision of milk in Classes 5(d) and (e), but the Panel decided to apply the principle of judicial economy and did not examine US claims under Article 3.

The AB reversed the Panel’s findings that Canada acted inconsistently with its obligations under Articles 3.3 and 8 of the Agriculture Agreement by providing export subsidies within the meaning of Article 9.1(a). However, it concurred that its scheme of Special Milk Classes 5(d) and 5(e) was inconsistent with 3.3 and 8 by providing export subsidies within the meaning of 9.1(c). It elected not to speak to coverage under Article 10.1.

*Tariff Rate Quota:* The final aspect of this case at the Panel level related to Canada’s tariff rate quota for imports of fluid milk, which provided for a quota of 64,500 tons, with differential duties for in-quota imports of 17.5% and over-quota imports of 283.8%. Access to the lower in-quota rate was restricted to “cross-border imports by Canadians of consumer packaged milk for personal use, valued at less than C\$20 per entry.” The United States argued that Canada’s restrictions on access to its tariff rate quota for fluid milk amounted to treatment less favorable to imports of fluid milk than it had provided in its WTO schedule, which thereby constituted a violation of GATT Article II.1(b).<sup>33</sup>

<sup>31</sup> With respect to the SCM Agreement, the Panel argued that item (d) of the Illustrative List (Annex 1) requires the presence of three elements: the provision of “imported or domestic products . . . for use in the production of exported goods, on terms or conditions more favourable than for provision of like or directly competitive products . . . for use in the production of goods for domestic consumption”; the provision of products by “governments or their agencies either directly or indirectly through government-mandated schemes”; and the “more favorable terms or conditions for such products for use in the production of exported goods . . .” (para 7.128).

<sup>32</sup> See para. 7.129.

<sup>33</sup> Article 11.1(b) provides that “the Products described in Part I of the Schedule relating to any contracting party, which are the products of territories of other contracting parties, shall, on their importation into the territory to which the Schedule relates, and subject to the terms, conditions or qualifications set forth in that Schedule, be exempt from ordinary customs duties in excess of those set forth and provided herein.”

By comparing the conditions applied by Canada on access to the tariff rate quota and the conditions set forth in its Schedule, the Panel found various differences in treatment and concluded that “by restricting the access to the tariff rate quota for fluid milk to (i) consumer packaged milk for personal use and (ii) entries valued at less than C\$20, [Canada] acts inconsistently with its obligations under Article II:1(b) of GATT 1994.”<sup>34</sup>

On appeal, the AB reversed certain features of the Panel’s determination on the question of the legal effect of the “conditions” as stated in Canada’s Schedule and it also reversed the Panel’s findings that restrictions of tariff rate quota to consumer packaged milk for personal use was a violation of GATT Article II.1(b).

The AB argued that the Panel failed to give appropriate legal effect to the “terms and conditions” of Canada’s schedule.<sup>35</sup> Finding the terms ambiguous, the AB turned to negotiating history and found that Canada’s commitment was understood to be a commitment to continue current access. However, given that there was a value limitation imposed by Canada, this feature of the tariff rate quota was inconsistent with GATT Article II:1(b).

### *3.3 Phase two: the 21.5 Panel determinations and AB reviews thereof*

Resolution of this dispute has proven elusive. On October 27, 1999, the DSB adopted the Panel and AB reports. It was agreed that the reasonable period of time for implementation would expire on January 31, 2001. After that date, the United States and New Zealand again challenged Canada for failing to comply with the recommendations of the DSB. The matter was referred to a Panel under Article 21.5, which found that the new measures were inconsistent with the WTO rules. This ruling was in turn appealed and the AB reversed on several important points of law. As discussed in greater detail below, it is this second AB ruling that has advanced the most significant interpretations of the Agriculture Agreement and its relationship to the SCM Agreement. This 21.5 proceeding also raised a number of procedural issues but the factual record is not discussed in any detail herein.<sup>36</sup>

<sup>34</sup> See para. 7.156.      <sup>35</sup> See para. 134.

<sup>36</sup> For example, the Panel denied Canada’s request to adopt procedures governing business confidential information; third parties were granted access to rebuttal submissions; the burden of proof requirements under the Agriculture Agreement 10.3 and 21.5 where the Panel held that Canada has the burden of proof with respect to 3.3, 9 and 10.

Subsequently, the United States and New Zealand requested a second Article 21.5 Panel to examine the revised Canadian measures and the second 21.5 Panel Report was released in July, 2002. As noted, Canada contested certain features of that second 21.5 Panel Report and the AB has issued a report on that second report.

**First 21.5 Panel Ruling:** As a result of the adverse ruling by the WTO DSB, Canada eliminated the Special Milk Class 5(e) and restricted Class 5(d) exports to Canada's export-subsidy-commitment levels. Canada did maintain its basic milk-supply management scheme, including an annual quota for industrial milk and allocation to producers and regulation of supplies and prices of different classes of milk through Classes 1 to 4. It also created a new class of domestic milk, Class 4(m), under which any over-quota milk could be sold only as animal feed. And the regime also included a new class of export-oriented milk labelled as "commercial export milk."

Under this commercial export milk (CEM), domestic producers can sell any quantity of commercial export milk to processors for export on terms that are freely negotiated between them. Such CEM sales do not require a quota or permission from the government and the revenues are collected without government involvement. If, however, a processed dairy product using CEM is sold on the domestic market, there are penalties applied to the processor for diverting such product to the domestic market.<sup>37</sup> The United States and New Zealand challenged that the CEM market system and the continued operation of Special Milk Class 5(d) was inconsistent with Articles 3.3, 8, 9.1c, and 10.1 of the Agriculture Agreement. The US argued that this revised scheme was inconsistent with Articles 1.1 and 3.3 of the SCM Agreement.

As discussed below, the 21.5 Panel held that the supply of CEM by domestic milk producers involves payments that are financed by virtue of government action, thereby making such payments inconsistent with Article 9.1(c) of the Agriculture Agreement.<sup>38</sup> This was also the main issue on appeal.

**9.1(c) The Question of Payments:** The first substantive issue that was addressed by the Panel was whether the measures amount to export subsidy "payments" under Article 9.1(c). The Panel argued that a determination that CEM is sold at discounted or reduced prices meets the standard

<sup>37</sup> See para. 4 of the AB Report.      <sup>38</sup> See para. 62–63.



of a transfer of economic resources as suggested by the AB in its statement outlining the meaning of 9.1(c). A judgment on what constitutes “below market rates,” as expressed by the AB in its review of the first Panel findings, requires in turn a judgment on the appropriate benchmark for prices. To the 21.5 Panel, the appropriate benchmark was the price of milk sold by producers domestically. The Panel also noted that an alternative benchmark was world market prices.

Canada argued on appeal that this determination by the Panel failed to fully appreciate that CEM is “no longer subject to government regulation.”<sup>39</sup> Further, it argued that CEM prices are freely negotiated in the market place and hence there is no “payment” when the producer sells CEM to a processor.

In the original proceedings, in order to determine whether there were payments under Special Milk Classes 5(d) and (e), the Panel had identified two benchmarks for comparing prices: domestic prices and the price of milk available to processors through imports under the Imports for Re-export Program. The Panel had found that the export prices were less than the prices under these two benchmarks. In its 21.5 appeal, Canada challenged the Panel’s pricing benchmarks that were used as a basis for determining whether or not there were “payments” within the meaning of the Agriculture Agreement.

The AB reviewed the history and concluded that when determining whether there are “payments” under article 9.1(c), the question turns to whether the price charged by the producer is less than the milk’s “proper value.”<sup>40</sup> This requires a comparison of prices actually charged for CEM and some objective standard or benchmark which reflects the proper value of the goods or services.

Before turning to the question of how to determine “proper value,” the AB examined the adjustments that Canada had made in its regulatory setting. It noted that CEM is now substantially deregulated and does not require governmental permits. However, it also took note of the fact that CEM cannot be directed to the domestic market and that the domestic price is an administered price that is favorable to the domestic producers. The AB argued that given this character of the overall environment, it was inappropriate to use as a benchmark and compare domestic prices (which are set by the government) with the CEM price that is freely negotiated. Hence, the AB reversed the Panel’s finding that the right benchmark is the domestic market prices.<sup>41</sup>

<sup>39</sup> See AB Report para. 69.

<sup>40</sup> See AB Report para. 73.

<sup>41</sup> See AB Report para. 81.

World market prices, another comparator identified by the 21.5 Panel, may provide one possible measure of the value of the milk to the producer. Looking at that price, however, still does not answer the fundamental question as to whether CEM can be sold competitively on world markets because it involves subsidies that make it competitive.<sup>42</sup> If the basis were world prices, the AB noted that “it would be possible for WTO members to subsidize domestic inputs for export processing while taking care to maintain the price of these inputs to the processors at a level which equaled or marginally exceeded world market prices. There would then be no ‘payments’ under Article 9.1(c) of the Agreement on Agriculture and WTO members could easily defeat the export subsidy commitments that they have undertaken in Article 3 on the Agreement on Agriculture.”<sup>43</sup>

Instead of looking to world market prices, the AB argued that the total cost of production, which reflected the fixed and variable costs which the producer must spend in order to produce the milk and the total amount that it must recoup, in the long term, to avoid losses, were the important variables for determining whether payments were made within the meaning of Article 9.1(c).<sup>44</sup> This formulation, in the view of the AB, struck the proper “harmony” with the disciplines under the Agriculture Agreement.

The AB noted that there could be some “spillover” effects between WTO-consistent domestic supports to exports. The distinction between domestic support and export-subsidy disciplines would be ended, however, if two consistent supports were automatically characterized as export subsidies because they produced spillover economic benefits for export production. At the same time, the AB noted that this notion could also not operate in an unbounded fashion. The best way to strike a balance between domestic and export supports, in the view of the AB, is to rely on the “total cost of production” to determine whether there are payments.

The “total cost of production” involves all fixed and variable costs. In circumstances such as this, where independent operators are making payments and where domestic prices are administered, the AB held that the average total cost of production is the appropriate standard for determining whether sales of CEM involve payments under 9.1(c). The AB then considered the factual findings made by the 21.5 Panel to see if it was possible to complete the analysis under what it had identified as the proper legal standard. It concluded that the record was not clear and the data was not sufficient.

<sup>42</sup> See AB Report, para. 84.

<sup>43</sup> Ibid.

<sup>44</sup> See *ibid.*, para. 88.

**The Question of Financing by Government Action:** As to the question of whether the payments are being “financed by virtue of government action,” the Panel formulated the issue as whether “milk processors for export have access to lower priced commercial export milk *but for* governmental action.”<sup>45</sup> The Panel considered that this standard would be met if it could demonstrate that *de jure* or *de facto* governmental action (i) prevents the Canadian milk producers from selling more milk on the regulated domestic market at a higher price than to the extent of the quota allocation to them; and (ii) obliges Canadian milk processors to export all milk contracted as lower-priced CEM and therefore penalizes the diversion of milk from the export market to the domestic market.<sup>46</sup>

The Panel argued that “the choice left to the Canadian producer is not a real choice.”<sup>47</sup> Since the government had taken away the first-best option, which was domestic sales, producers would rationally opt for the second-best possibility, export sales. The Panel found that CEM “would not be available to Canadian producers but for . . . the federal and provincial actions . . . obliging producers, at least *de facto*, to sell outside quota milk for export.”<sup>48</sup>

The AB disagreed that producers are obliged or driven to produce additional milk for export sale. However, the AB acknowledged the logic of the Panel’s reasoning as a means of establishing a *demonstrable* link between governmental action and the financing of payments. Given its judgment to reverse on the issue of payments, the AB did not feel it necessary to consider the Panel’s findings on the phrase “financed by virtue of governmental action” with any further detail.

On the issue of Article 10.1 of the Agriculture Agreement, given that the AB was unable to speak of the legal character of the measure under Article 9.1, it was unwilling or unable to discuss the legal character of the measure under Article 10.<sup>49</sup>

#### 4 The second 21.5 Panel and AB rulings

New Zealand and the United States requested the establishment of a second 21.5 panel to evaluate the consistency of the Canadian measures with

<sup>45</sup> See *ibid.*, para. 107.      <sup>46</sup> See Panel Report, paras. 6.41–6.42

<sup>47</sup> See *ibid.*, para. 6.45.      <sup>48</sup> *Ibid.*, para. 6.42.

<sup>49</sup> With respect to the claim under Article 3.1 of the SCM Agreement, the AB held that a WTO-consistent subsidy for exports must be reviewed under the Agriculture Agreement and since there is not final determination under Article 9 thereof, it cannot opine on Article 3 of the SCM Agreement.

the DSB rulings and Canada appealed. Given the rulings of the AB in response to the first 21.5 panel report, it is hardly surprising to see the complainants seeking additional consideration of the meaning of what the AB had stated to be the proper methodology for evaluating the existence of a subsidy – namely, the average total cost of production. The brief summary that follows focuses primarily on the evolving clarification of this concept.

#### 4.1 *The question of payments redux*

The second 21.5 panel proceedings brought to the surface two alternative formulations of what constituted “average total cost of production.” The complainants argued that the cost of production should be interpreted to mean industry-wide average costs with industry-wide average CEM prices along with imputed costs. The objective would be to determine whether prices are below the average total cost of production. Canada, in contrast, argued that individual producer costs were the appropriate comparison, excluding imputed and certain other costs. The Panel appeared not to have confidence in the data presented by Canada as being complete and instead represented an “extrapolation” regarding individual producer prices.<sup>50</sup> It expressed doubts that the individual producer’s costs should be the basis for the determination. The Panel also argued that the evidence did not support Canada’s position that payments were not made and it ultimately elected not to opine on which methodology was definitive.<sup>51</sup> It also disagreed with Canada on the exclusion of other costs.

The AB ruling on this second 21.5 panel upheld the basic finding.<sup>52</sup> On the methodology, however, the AB went further and suggested that the nature of the obligations imposed under the Agriculture Agreement speak to export subsidies provided through private party action. And the AB suggested that the question “is not whether one or more individual milk producers, efficient or not, are selling CEM at a price above or below their individual costs of production. The issue is whether Canada, on a national basis, has respected its WTO obligations.”<sup>53</sup> As a result of this perception of the Agreement implicating a national obligation, the AB suggests that the benchmark should be a “single, industry wide cost of production figure rather than an indefinite number of cost of production

<sup>50</sup> See Panel Report, para. 5.63. <sup>51</sup> See, *ibid.*, paras. 5.65, 5.87.

<sup>52</sup> The AB disagreed with the Panel’s treatment of burden of proof, but nevertheless did not disagree with the overall conclusion.

<sup>53</sup> See, AB Report *Canada – Dairy*, para. 96.

figures for each individual producer.”<sup>54</sup> The AB further held that all costs should be included.

On the question of whether these payments were “financed by virtue of governmental action,” the Panel focused on a number of attributes of the scheme and its incentives, and concluded that Canada had failed to establish that governmental action is not demonstrably linked to these payments.<sup>55</sup> The AB upheld this finding and articulated for the first time a detailed interpretation of this provision. It reiterated the view that “payments” can be made by private parties and need not be made by the government, and the standard requires careful scrutiny of the factual and regulatory setting.<sup>56</sup> Indeed, the AB argued that governmental action can be an act or an omission, and the scope of government action includes circumstances where no compulsion is involved in the making of payments.<sup>57</sup>

With respect to the terminology “by virtue of,” the AB argued that simply enabling payments was insufficient, a “tighter nexus” between the mechanism or process by which the payments are financed being necessary.<sup>58</sup> With respect to the question of financing, the AB accepted that it could encompass situations where significant aspects of financing might not involve the government, but the government “must play a sufficiently important part in the process by which a private party funds payments, such that the requisite nexus exists between ‘governmental action’ and ‘financing.’”

On the facts of this case, the AB focused on the issue that milk was produced “using a single line of production, but sold in two different markets,” and the fixed costs of production are shared. Moreover, the AB stressed that the price of milk is fixed by a governmental agency that has a statutory mandate to ensure a “fair return” for “efficient producers.”<sup>59</sup> It also emphasized that “governmental action” controls virtually every aspect of domestic milk supply management, a fact which ensures a highly remunerative system for domestic milk producers which covers their fixed costs and permits them “to sell export milk at prices that are below the costs of production.”<sup>60</sup>

#### 4.1.1 Comments and questions on legal and policy matters

As noted at the beginning of this study, the Agricultural Agreement has been seen as an accomplishment in no small measure because it set up a

<sup>54</sup> *Ibid.*      <sup>55</sup> See, Panel Report, paras. 5.133–5.135.

<sup>56</sup> See AB Report, para. 87.      <sup>57</sup> *Ibid.*, paras. 127–28.

<sup>58</sup> *Ibid.*, paras. 129–31.      <sup>59</sup> *Ibid.*, paras. 132–41.      <sup>60</sup> *Ibid.*, para. 145.

framework of rules for evaluating agricultural supports and because countries committed to phased reductions or improvements in the three core areas of domestic supports, export subsidies, and market access commitments. Of these, legal experts are often inclined to see the rules on export subsidies as representing the clearest improvement made by the Agricultural Agreement as compared with the GATT rules, particularly when reflected in numerical commitments in country schedules.<sup>61</sup>

Yet neither the Agriculture Agreement nor the SCM Agreement provides a complete methodology for interpreting core concepts – e.g. what constitutes a “subsidy,” whether there is a “payment,” and what is deemed an empirically sound and consistent basis for a judgment on that point. And it remains to be seen whether the definitions will prove workable. With respect to the second example, on payments, the 21.5 panel elected to focus on domestic and world market prices as a means of arriving at a judgment on this question, in an environment of a price floor and production ceilings. That Panel’s approach seems to be founded, in part, on the AB’s response to the first Panel methodology, and in the first review by the AB it stressed that “below market rates” was decisive. Given that guidance by the AB, the 21.5 Panel’s decision to focus on internal (domestic) and external (world) prices is understandable. But then the AB went a step further and identified another standard, “total cost of production,” because it argued that an “objective benchmark” was necessary, which implied the price methodology was not.

The AB’s formulation in response to the 21.5 Panel Report appears to be an altogether new methodology for determining the existence of a “payment.” Putting aside for the moment whether it represents an improved economic rationale, as a matter of legal methodology this approach does not seem grounded in a strict legal interpretation of the applicable agreements. In other words, neither the Agricultural Agreement nor the SCM Agreement explicated the use of this methodology. Moreover, since this methodology was not delineated in the covered agreements, not surprisingly the parties had generated a factual report that permitted neither the Panel nor the Appellate Body to complete the analysis. Having called certain pertinent facts and the applicable methodology into question, the AB was unable to reach a judgment on the law, and the case was sent back to be re-reviewed by a second 21.5 Panel. In a word, it appears that the

<sup>61</sup> See, Hudec, (1998 draft), “Does the Agricultural Agreement Work?” available at <http://www.harvard.cid.edu>. GATT/WTO Constraints on National Regulation: Requiem for an Aims and Effect Test, 32 *International Lawyer*, 619–649.

AB developed its own methodology because it was dissatisfied with that employed by the Panel.

The second Panel was in turn understandably hesitant to be conclusory with respect to the methodology that might be used as a reliable basis for determining total average production cost. At a minimum, the AB had not spoken on this point in sufficient detail to guide the Panel. As between industry averages and firm specific information, the Panel leaned in the direction of industry averages, partly owing to the nature of the data that was presented to it in this instance. The AB took this a step further and affirmatively supported the notion of industry averages under the stated logic that WTO obligations flowed to the nation as a whole and hence this aggregate data was more appropriate.

We shall turn presently to an overall economic assessment of this case. The legal reasoning and stated logic on this single methodological point, however, also warrants further consideration. The AB introduced whole cloth the concept of “average total cost of production” because it was thought to offer a more precise basis for determining whether a payment is present. In the following section, we question the reliability of that measurement. Nevertheless, using the logic articulated, would it not make more sense to lean toward the methodology that delivers the most rigorous and precise assessment possible of actual costs? If so, that would lead one toward developing detailed firm-specific data and then aggregating and averaging that data. If such detailed micro-economic data is not available then other methodologies might need to be utilized so it may not be the only choice available.

Hence, the AB could have attempted to delineate or articulate some hierarchy of possible approaches, leaning to the most rigorous method available in the first place. Instead, it chose to reject the microeconomic methodology because it considered this analysis as firm-oriented while WTO obligations occur at the level of the nation-state. Given that this provision is attempting to assess the impact of government action on private costs, it is curious not to see the aggregation of such firm-level data as a more precise starting point than some general averages.

From a legal and policy perspective, this case is also noteworthy for its treatment of State responsibility and attribution. The issue of public versus private conduct and the scope of government measures that can come under the GATT/WTO system has surfaced periodically for many years.<sup>62</sup> There have been several GATT/WTO cases that considered the

<sup>62</sup> See, for example, a 1960 GATT study that looked at the question of whether subsidies financed by a governmental levy were notifiable under Article XVI. That study stated that

extent of government responsibility over the actions of private parties and the outer limits of what constitutes a government measure. *Canada – Dairy* reviewed that issue in the context of a particular covered agreement. In *Japan – Semiconductor*, the GATT panel held that even non-binding administrative guidance by the Government of Japan could constitute a “government measure” if certain criteria were met.<sup>63</sup>

Later, in *Japan – Film*, the WTO held against the US complainant on the facts of the case but on the general question of actionable government measures, the panel built upon the semiconductor case to support an expansive view of government-covered measures.<sup>64</sup> That Panel noted that “past GATT cases demonstrate that the fact that action is taken by private parties does not rule out the possibility that it may be deemed to be governmental if there is sufficient government involvement with it . . .”<sup>65</sup>

Within the context of Article 9.1(c) of the Agricultural Agreement, we see in *Canada – Dairy* even more detailed consideration of the extent of government responsibility over private practices, which the respondent had asserted were fully deregulated private sector decisions. As discussed above, the 21.5 Panel’s interpretation of the extent of government

the “question depends on the source of funds and the extent of government action, if any, in their collection” (Report on Review Pursuant to Article XVI:5, adopted on May 24, 1960 BISD 9S/188 192).

<sup>63</sup> See Report of the GATT Panel (adopted), *Japan – Trade in Semiconductors*, BISD 35th Supp. 116, at 155 (1988). In that case, which involved restraints on exports of semiconductors by the Government of Japan, the specific criteria identified by the panel included (1) that reasonable grounds exist for believing that the government measures created sufficient incentives to persuade private parties to conform their conduct to the non-mandatory measures, and (2) that the effectiveness of the private conduct was “essentially dependent” on the non-mandatory actions taken by the government.

<sup>64</sup> See WTO/DS44/R (*Japan – films*). The Panel found that “government policy or action need not necessarily have a substantially binding or compulsory nature for it to entail a likelihood of compliance by private actors in a way so as to nullify or impair legitimately expected benefits within the purview of Article XXIII.1(b). Indeed, it is clear that non-binding actions, which include sufficient incentives or disincentives for private parties to act in a particular manner can potentially have adverse effects on competitive conditions of market access.” Another case that involved private activities was *Restrictions on Imports of Dessert Apples*, which involved market withdrawal of fruits by consumer organizations. That Panel found that the formal system for apples was a hybrid one, and the buy in and withdrawal systems could be considered a government measure. See, *Restrictions on Imports of Dessert Apples* adopted on June 22, 1989, 36th Supp BISD 93, 1990 BISD 93, 1990.

<sup>65</sup> See *Japan – films* (WT/DS44/R), para. 10.56. That panel also looked to the semiconductor panel report for the proposition that “where administrative guidance creates incentives or disincentives largely dependent upon government action for private parties to act in a particular manner, it may be considered a government measure.” See paras. 10.43–10.46.



responsibility hinged on a “but for” standard. The AB held that there had to be a “demonstrable link” between the government action and the financing of payments. The final articulation of that link by the AB goes quite some distance into the deconstruction of what constitutes “payments financed by virtue of governmental action.” In making its evaluation, the AB has indicated a willingness to consider the entire regulatory scheme and its consequences for private entities. In this case, private activities were seen as having lost (or never having had) their private character, operating as they were under the comprehensive supply management scheme.

### 5 Specific economic analysis

We now consider and evaluate the particular legal and economic issues and methodologies raised by the dispute. More specifically we ask: in light of the underlying goals of the relevant WTO provisions, and taking them as given, was the resolution of the substantive economic issues around which the case revolved based on sound economic principles? The central substantive economic issue of this case concerns the identification of export subsidies, and more specifically the methodology for detecting the presence of “payments” to exporters within the meaning of Article 9.1(c) of the Agriculture Agreement.

The AB report in response to the first 21.5 Panel determination (especially paragraphs 89–92) provides the rationale for the measure of “payments” to exporters of processed dairy products that was proposed by the AB, namely, the difference between the average total cost of domestic milk production and the milk price paid by exporters of processed dairy products. In essence, the AB suggests that the milk’s “proper value” is its average total cost of production; and further the AB suggests that, measuring proper value in this way, its methodology for measuring payments strikes a balance between, on the one hand, permitting domestic supports for milk producers even when these supports may have some “spillover” economic benefits for exporters of processed dairy products, and on the other, not going so far as to permit the provision of unlimited support for exporters of processed dairy products so long as this support is generated by the domestic support provisions for milk producers.

This raises a key question: Does the suggested comparison of the average total cost of milk production with the milk price paid by exporters of processed dairy products provide a reliable measure of how much support exporters of processed dairy products are receiving? By way of the

following hypothetical scenarios, we suggest that the reliability of the measure suggested by the AB is problematic. We then reconsider an alternative measure of proper value which the AB considered and rejected, namely world market prices.

### *5.1 What is wrong with average total cost as a measure of proper value?*

Consider the following hypothetical scenario. Suppose that a government wishes to redistribute income from its general population toward its dairy farmers, who are currently earning a below-normal economic rate of return on their sunk investments (e.g. dairy cattle, land improvements tailored toward dairy farming, physical and human capital specific to the dairy industry) but, due to the “sunk” nature of these investments, do not find it in their economic interest to exit from dairy farming.<sup>66</sup> Suppose further for the sake of argument that this country is initially a textbook *laissez-faire* perfectly competitive market economy, and that it is an exporter of processed dairy products (“cheese”) on world markets (and for simplicity, let us assume for now that unprocessed milk is not directly tradable internationally, due perhaps to high costs of transport).

To accomplish the desired redistribution, suppose that the government imposes a tax on all milk that is consumed by domestic households – whether consumed directly, or rather indirectly in the form of cheese – and uses the revenue generated by this tax to pay for direct “lump-sum” transfers to its dairy farmers. Should this program be viewed as providing an export subsidy to cheese exporters?

The immediate reaction to this question would probably be a puzzled look and the answer “Of course not.” However, a little reflection reveals that the country’s exports of cheese on world markets would likely rise as a result of this program, and so the answer may not be quite as obvious as it first appears. Still, upon further reflection, most observers would probably agree that the answer to this question is “No.” It is true that, under typical economic conditions, the impact of this program would be to increase the country’s cheese exports. But the increased exports would not come about as a result of “payments” made to domestic producers of cheese as a reward for exporting. Instead exports, which we now recall are simply the difference between a country’s domestic production and its domestic

<sup>66</sup> Introducing other fixed costs of production that are not also sunk would leave unaltered the basic argument.

consumption, would increase with the introduction of this program only because domestic consumption of cheese would be reduced.

In fact, total domestic production of cheese at given world prices would not be altered at all with the introduction of this program: each domestic cheese producer can always export all of its production to world markets and receive the given world price for its foreign sales, and so the domestic production of cheese continues to occur at the point where this (unchanged) world price equals the (unchanged) domestic marginal cost of cheese production. Moreover, these producers would be willing to sell cheese to domestic consumers only if the producers receive this same (i.e. world) price for domestic sales. This means that the full incidence of the milk tax will be passed on to domestic consumers of cheese, who will see the prices they pay for cheese rise by the full cost implications of the milk tax.

As a consequence, the total quantity of cheese produced in the domestic country at a given world price is unchanged with the introduction of this program. And the increased exports at a given world price associated with the introduction of this program would come about as a result of the diminished domestic consumption of cheese, which in turn results from the tax-induced price increase for cheese faced by domestic consumers. For these reasons, any export effects of the program will be dependent upon features of domestic demand for cheese (such as how “price elastic” this demand is).

Figure 10.2 illustrates the main ideas. In the left-hand quadrant of figure 10.2, the price of cheese charged by domestic cheese producers is measured on the vertical axis while the quantity of cheese is measured on the horizontal axis. As there are assumed to be no impediments to the export of cheese, the price of cheese charged by domestic producers for domestic sales, which we denote by  $p$ , must be the same as the price these producers could charge for sales on the world market, which we denote by  $p^*$  (that is, we must have  $p = p^*$ ). The quantity of cheese supplied by domestic producers (for domestic or foreign sales) at any given producer price  $p$  is then depicted as the upward-sloping curve in the left-hand quadrant of figure 10.2, which we label  $S(p)$ . In the absence of a tax on the domestic consumption of milk and the milk content of cheese, domestic demand for cheese is depicted by the downward-sloping curve in the left-hand quadrant, which we label  $D_0(p)$ .

At any given world-market price  $p^*$ , we may use the fact that  $p = p^*$  to determine the export supply of cheese from the domestic country as

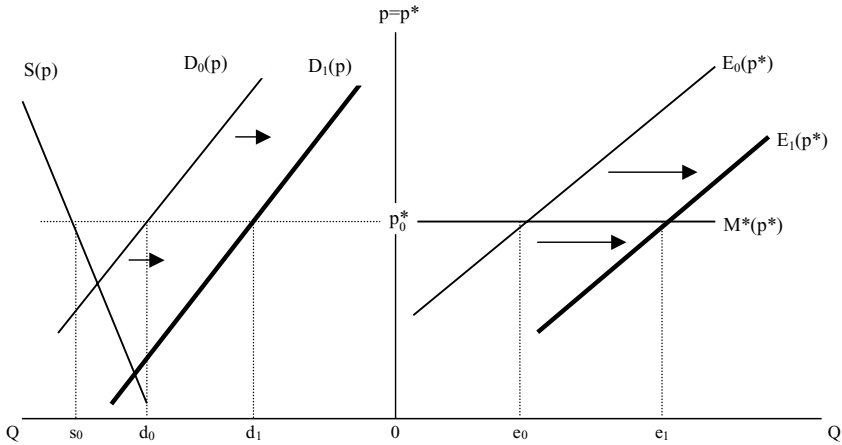


Figure 10.2

the difference between domestic supply and demand in the left-hand quadrant. This difference is plotted in the right-hand quadrant of figure 10.2, which measures  $p^*$  on the vertical axis and the quantity of cheese on the horizontal axis, and the associated domestic export supply curve for cheese is labeled  $E_0(p^*)$ . The foreign import demand for cheese can be plotted in the right-hand quadrant of figure 10.2 as well, and it is depicted as the horizontal line labeled  $M^*(p^*)$ .<sup>67</sup> As shown in the two quadrants of figure 10.2, in the absence of a tax on the domestic consumption of milk and the milk content of cheese, domestic cheese producers make domestic and foreign sales at a common price level equal to  $p_0^*$  and supply a quantity of cheese equal to  $s_0$ , while domestic cheese consumers pay the price  $p = p_0^*$  and demand a quantity of cheese equal to  $d_0$ , with the difference between  $s_0$  and  $d_0$  corresponding to the volume of cheese exported to world markets by the domestic country,  $e_0$ .

Now consider the impact in the cheese market of a tax on the domestic consumption of milk and the milk content of cheese. Since domestic cheese producers can continue to sell all the cheese they want on world markets and receive the world price  $p^*$  (this is reflected in the horizontal foreign import demand curve  $M^*$ ,  $p^*$ , in the right-hand quadrant of figure 10.2), these domestic cheese producers will only sell cheese to

<sup>67</sup> The horizontal foreign import demand curve reflects the simplifying assumption that the domestic country is “small” on world markets. This assumption simplifies the exposition, but is inessential to the point being made.

domestic consumers if they continue to receive  $p = p_0^*$  for each unit of cheese sold on the domestic market. This implies that domestic cheese consumers must bear the entire incidence of the tax, and therefore must pay a higher price for each unit of cheese consumed in order to cover the tax payment collected by the government and still provide domestic cheese producers with a price  $p = p_0^*$ . In terms of the left-hand quadrant of figure 10.2, this implies that the domestic demand curve shifts back to the bold curve labeled  $D_1(p)$ .

The right-hand quadrant of figure 10.2 depicts the implication of this shift in domestic cheese demand for the domestic export supply curve, which shifts out correspondingly to the bold curve labeled  $E_1(p^*)$ . As depicted, the impact of the milk-tax-and-redistribution program described above is then to reduce domestic cheese demand to the quantity  $d_1$  and raise domestic exports of cheese to the quantity  $e_1$ , without altering the quantity of cheese produced in the domestic country from its initial level of  $s_0$ .

In light of the above discussion, it seems reasonable to conclude that this program offers no support whatsoever to domestic cheese producers, whether this cheese is produced for the domestic market or for export: the domestic production of cheese is simply unaffected by the milk-tax-and-redistribution program. By this logic, the program could not be interpreted as an export subsidy to domestic cheese producers, even though it will typically result in some “spillover” increase in domestic exports of cheese. And indeed, if we apply the methodology suggested by the AB for calculating “payments” to cheese exporters, we would find that the payments are zero, provided that proper account were taken of the below-normal economic profit rate earned by domestic dairy farmers that we assumed at the start.

The simple point is, under this program, domestic milk producers will receive the same price for their milk from every buyer, whether that buyer is a final domestic consumer of milk or an industrial milk processor (i.e. “cheese” producer): there is no “cross-subsidization” implied by the pattern of domestic-milk sale prices. Hence, the milk price received by a domestic milk producer will bear the same relation to its average total cost, regardless of whether this milk is sold for domestic consumption or to be processed for export. And the relation between price and average total cost will be an equivalence relationship, and measured payments will therefore be zero, provided that the costs of the sunk factors are calculated appropriately (i.e. they are imputed as a residual return on each dairy farmer’s milk production).

Consider now an alternative redistribution program, in which the government (i) announces a regulated price (above the initial price) at which all domestically produced milk consumed by domestic households – whether consumed directly, or indirectly in the form of cheese – is to be sold; (ii) imposes a prohibitive tariff on cheese imports; (iii) institutes a quota system to allocate domestic milk sales among domestic dairy farmers; and (iv) allows domestic dairy farmers to continue to make unregulated milk sales at unregulated “market” prices for milk that is used in the production of cheese for export. Should this program be viewed as providing an export subsidy to cheese exporters?

On its face, this program looks like a complicated scheme for increasing the incomes of dairy farmers through a system of domestic supports that keep domestic milk prices high while permitting the “excess” milk production to become available at low (“cross-subsidized”) prices to the exporters of processed dairy products. And this sounds suspiciously like an export subsidy to exporters of processed dairy products.

However, it can be shown that, for any tax level chosen under the first program described above, there is an associated regulated price level under (i) and system of quotas under (iii) that together with (ii) and (iv) make the second program *identical* to the first program in every relevant economic dimension. Essentially, both programs orchestrate a redistribution from the domestic consumers of milk and cheese to the domestic milk producers, and both programs accomplish this by facing domestic consumers with higher prices for their (direct and indirect) milk consumption. The only difference between the two programs is the method by which domestic dairy farmers receive the “transfer”: under the first program, they receive this transfer as a lump sum distribution of tax revenue from the government, while under the second program they receive the transfer “directly” in the form of higher regulated milk prices. This difference, though, is immaterial to each and every production and consumption decision in the domestic economy.

In essence, figure 10.2 applies (with some appropriate programmatic re-labeling) as a description of the impact of the milk program on the cheese market, whether the milk program takes the first (tax-based) form or the second (regulation-based) form. In analogy with the tax-based program, it can be argued using figure 10.2 that with the introduction of the regulation-based program, the higher regulated price of milk paid by domestic households for their direct and indirect milk consumption shifts the domestic demand for cheese back, but leaves the domestic supply curve

for cheese unaffected, with the consequent outward shift of the domestic export supply curve for cheese.

Hence, if it is agreed that the first program described above does not qualify as an export-subsidy program, then the second program logically cannot either. And yet, under the methodology suggested by the AB for calculating “payments” to cheese exporters, we would find that the payments are positive, provided that proper account were taken of the impact of the regulatory program on the profit rate for milk producers.<sup>68</sup>

The simple point is, under this second program, domestic milk producers will receive the high domestic regulated price for milk sales that ultimately find their way to domestic consumers, while these producers will receive a lower unregulated price for milk sales that are used to produce exports: there is now a degree of “cross-subsidization” implied by the pattern of domestic-milk sale prices. As a consequence, the milk price received by a domestic milk producer will be higher in relation to its average total cost when this milk is sold for domestic consumption than when it is sold to a processor for eventual export. And since the average price across all milk sales must equal the average total cost (again, provided that the costs of the sunk factors are calculated appropriately, i.e. they are imputed as a residual return on each dairy farmer’s milk production), a finding that the average total cost of domestic milk production is above the price of milk paid by export processors – that is, a finding of positive payments to exporters of processed dairy products – is assured.<sup>69</sup>

Hence, the pattern of domestic-milk sale prices under this second program will appear as “cross-subsidization” of cheese exporters, even though the program itself has identical economic implications to the first program described above, and therefore has no impact whatsoever on the domestic production of cheese whether destined for the domestic or export

<sup>68</sup> At a more specific level, this discussion also raises a question as to whether the Canadian Dairy Program should in fact be seen as operating as an export subsidy program. If the second program described above captures the essence of the Canadian Dairy Program, then as we have observed above the domestic production of processed dairy products would be unaffected by this program, and it can then be argued that this program should not be seen as an export subsidy program within the meaning of the Agriculture Agreement. As this is not our main point here, we simply raise the possibility and leave a more careful assessment of this possibility for future work.

<sup>69</sup> In effect, we are arguing that in the presence of sunk investments, a comparison of average total cost of milk production to milk price is guaranteed to imply positive “payments” to any processor that pays less than the average milk price. Hence, if exporters do not have to pay the high regulated price of milk that processors for domestic consumption must pay, then the methodology proposed by the AB will indicate that these exporters are receiving payments.

markets. Moreover, in this case the second step of the AB's methodology for determining the presence of export subsidies will be met as well: the payments so defined will be "financed by virtue of government action," since it is true that without the government's regulatory program this "cross subsidization" would not occur.

This suggests a basic and fundamental problem with the methodology for identifying the presence of export subsidies as suggested by the AB. In effect, whenever sunk investments earning a below-market rate of return are present – a condition that is likely to be met in "declining" industries that are also the most likely to be receiving domestic support – the measurement of average total cost for use in the AB's suggested methodology becomes problematic. If the rental costs of the sunk investments are imputed as their residual returns in the industry, then the measured average total cost must equal the industry average price. This "endogeneity" between the prices charged in the industry and the measured average total costs implies in turn that the AB's methodology will find that payments are being received by any purchaser of the products of that industry that pays a price below the industry average price. As the hypothetical scenario considered above illustrates, this does not provide a reliable guide for identifying the presence of export subsidies.

An alternative measurement procedure would be to exclude fixed costs that are also sunk from the calculation of average total cost for the purposes of the AB's methodology. This alternative procedure would solve the "endogeneity" problem described above, but it would lead to other problems. For example, this alternative procedure would overlook a government subsidy program that induced suppliers to offer low prices to some buyers when they would not have done so absent the government program, but where the low prices are not so low as to fall below the measured average total cost. A related, though perhaps less relevant, flaw in the AB methodology is that, by basing its proposed calculation of average total cost on the assumption of an "ordinary" profit rate (paragraph 95), the methodology could overlook subsidy payments in an industry where profits were extraordinarily high.

Finally, it is interesting to observe that in the second 21.5 Panel Report, a central part of the dispute revolved around whether imputed costs should be included in the average total cost calculation or not. The US and New Zealand (complainants) argued for including these imputed costs, much as we have done in our hypothetical scenario above, while Canada argued for excluding them. The Panel chose not to rule on which procedure for measuring the average total cost was correct, stating that ". . . we have



made findings of the existence of ‘payments’ based on both the Complainants’ and Canada’s interpretation of how to apply the Appellate Body’s benchmark, thus making it unnecessary to decide *in this* case which of these two interpretations is the correct one” (paragraph 5.90). In its second report on the 21.5 Panel, the AB offered further guidance on its proposed methodology, stating (paragraph 110) that imputed costs should indeed be included in the calculation of average total cost.

We have illustrated here by way of our hypothetical scenarios a difficulty with including imputed costs in this calculation, but as we have observed above there are also obvious difficulties with excluding such costs from the calculation. As a consequence, we would suggest that neither of these approaches is likely to be entirely satisfactory, and further analysis of this question seems appropriate and important.

### 5.2 *What is wrong with world market prices as a measure of proper value?*

In light of the difficulties in the AB’s suggested methodology as pointed out in section 5.1 above, we suggest briefly here that the AB might usefully reconsider an approach to the measurement of “proper value” that it had previously considered and rejected, namely, world market prices. In rejecting this measure of proper value, the AB argued in its response to the first 21.5 Panel determination (paragraph 84) that, since it would be possible that CEM could be sold at terms competitive with world market prices precisely because CEM involves subsidies that make it competitive, “. . . a comparison between commercial export milk prices and world market prices gives no indication on the crucial question, namely, whether Canadian export production has been given an advantage.” The implication of this statement appears to be that Canadian export production will have been given an advantage if and only if CEM prices do not reflect the milk’s “proper value,” which is to say that CEM prices do not cover the average total cost of milk production.

Why, though, should it be concluded that Canadian export production has been given an advantage in this circumstance, if the CEM price simply provides cheese exporters with an alternative and *equivalent-cost* source of milk supply to the supply that can be attained from world markets? Put differently, what advantage can cheese exporters be receiving if they are essentially indifferent between buying milk inputs on the world market at world market prices and buying milk inputs instead on the domestic market from (possibly subsidized) domestic milk producers? From this

perspective, a comparison between CEM prices and world market prices would seem to provide a reasonable measure of the precise amount of the advantage which could be deemed a “payment” to exporters under Article 9.1(c) of the Agriculture Agreement.

We therefore suggest, to the extent that purchases of milk on world markets is an option that is readily commercially available to processors of milk products, that world market prices of milk are a reasonable comparator to the CEM price, and that under this comparison the existence of “payments” within the meaning of Article 9.1(c) of the Agriculture Agreement could be reasonably determined. In light of the limitations of the AB’s suggested methodology in this regard, reconsidering the use of world market prices in this fashion may be appropriate.

## **6 Concluding observations on the legal tests and economic analysis**

This final section summarizes the relationship between the legal rules and economic assessments of the analyzed dispute. In general, we are of the view that the problematical aspects of this case do not stem from problems in legal drafting. Instead, this case points out complexities associated with the underlying conceptual foundations of the Agriculture Agreement. It provides some questions as to whether the treaty rules and the AB-developed methodologies are fully workable. Turning first to the conceptual foundations of the case, we make the following broad economic observations.

First, the overall approach to export subsidies within the GATT/WTO lacks a sound economic underpinning. As the discussion of exporter versus importer interests in section 2.1 above sought to reveal, even in a world of bound tariffs importing nations have some tools under the WTO to respond to the perceived adverse effects of export subsidies – e.g. through the imposition of countervailing duties or renegotiation of tariffs. Thus, additional prohibitions on export subsidies do not factor in the full economic interests of all importing nations. From this perspective, such prohibitions do not serve the interests of importing governments’ – or world – welfare. This conclusion runs counter to the long history of efforts in the GATT/WTO to eliminate export subsidies, but it is derived from formal economic thinking under standard arguments.

We have offered two interpretations of this conclusion. A first interpretation emphasizes the limits of existing formal economic reasoning in

this instance, and casts doubt on the ability of existing formal economic models to adequately capture the role that international agreements to limit export subsidies can play. According to this interpretation, it is important to seek and develop further alternative modeling approaches that might better reflect some critical feature associated with the issue of export subsidies that the standard models have failed to capture. A second interpretation would place more weight on the presumptions implied by the standard economic arguments reviewed above, and this second interpretation casts doubt on the rationale for international agreements to limit export subsidies.<sup>70</sup>

At the least, the conclusion we report in section 2.1 reflects the need for further articulation of the rationale for the treatment of export subsidies within the GATT/WTO. At most, the GATT/WTO's approach to export subsidies might benefit from a fundamental overhaul.

Second, our analysis points to a basic and fundamental problem with the methodology for identifying the presence of export subsidies as suggested by the AB in the *Canada – Dairy* case. We appreciate the systemic tension faced by the AB and the Panels, in that the Agriculture Agreement permits domestic supports and prohibits export subsidies in excess of reduction commitments, and the adjudicators are then faced with a dilemma as to how to give both effect when the domestic subsidy fosters the export subsidy. However, the particular methodology developed by the AB, as we argued, does not isolate the presence of export subsidies.

In effect, whenever sunk investments earning a below-market rate of return are present – a condition that is likely to be met in industries receiving domestic support – the measurement of average total cost for use in the AB's suggested methodology becomes problematic. If the rental costs of the sunk investments are imputed as their residual returns in the industry, then as an accounting matter the measured average total cost must equal the industry average price. This implies in turn that the AB's methodology will find that payments are being received by any purchaser of the products of that industry that pays a price below the industry average price. As the hypothetical scenario considered in our analysis above illustrates, this does not provide a reliable guide for identifying

<sup>70</sup> In this regard, the conclusion we report in section 2.1 may be difficult to accept for those who put emphasis on other, less analyzed or proven factors such as transaction costs, the stage of economic development of the importing country, the perception that export subsidies are particularly aimed at transferring the costs of adjustment abroad, etc. The lawyer co-author here is not fully convinced, although appreciative, of the force of overall economic observation on the effects of export subsidies.

the presence of export subsidies. This suggests the possible advisability of additional legal text within the GATT/WTO Agreements that would offer guidance to member governments in their identification and calculation of export subsidies, along the lines offered in the WTO Agreement on Implementation of Article VI.

In light of the problems with the AB's suggested methodology in this regard, we also suggest an alternative: to the extent that purchases of milk on world markets is an option that is readily commercially available to processors of milk products, world market prices of milk are a reasonable comparator to the CEM price, and under this comparison the existence of "payments" within the meaning of Article 9.1(c) of the Agriculture Agreement could be reasonably determined. While the AB considered and rejected the use of world market prices as a measure of milk's "proper value," we suggest that reconsidering the use of world market prices in this fashion may be appropriate.

Turning now to the legal character of the case, we have considered issues such as the approach to treaty interpretation taken by the reviewing Panel and the AB. How broadly or narrowly did the reviewing body define its mission? Within the body of relevant WTO case law, was the case reviewed in a manner consistent with past WTO practice? How might we evaluate the legal methodology employed?

*Canada – Dairy* has already produced a long record. Despite the absence of formal remand authority under the rules of the DSU, this case has already produced two 21.5 panels and three AB rulings. It has been a particularly noteworthy case from a legal perspective in that it represented the first interpretation of the Agriculture Agreement. The findings of the AB with respect to the methodology appropriate for evaluating whether an export subsidy was present was particularly novel. As the economic discussion showed, the methodology may not introduce meaningful or reliable economic distinctions.

This case also considered the SCM Agreement to a limited degree. In this regard, it is interesting to compare *Canada – Dairy* to the *US – Export Restraints* case (see our companion review of that case). The *US – Export Restraints* case was centrally focused on the SCM Agreement. These two cases viewed together do not present a coherent or comprehensive set of interpretations on the relationship between the SCM Agreement and the Agriculture Agreement. More specifically, how the definition of export subsidies in the SCM Agreement should inform interpretations of the Agriculture Agreement has not been well clarified by these two cases. The Canadian government invoked the SCM Agreement (notably

Article 1.1(a)(iv) and *US – Export Restraints*) as important contextual guidance for interpreting Article 9.1 (c) of the Agreement on Agriculture. If that case and its ruling regarding Article 1 of the SCM Agreement were applied in the context of *Canada – Dairy*, it would suggest a somewhat narrow range of governmental action that would be sufficiently targeted and purposeful to meet the terms of the Agriculture Agreement.<sup>71</sup> As of this time, the exact relationship between the SCM Agreement and the Agriculture Agreement remains to be clarified and will doubtless take place over a period of some years.

### References

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<sup>71</sup> The second 21.5 Panel tried to speak more generally to the question of the extent to which the SCM Agreement informs or provides guidance to the Agriculture Agreement, notably with regard to the definition of prohibited export subsidies in Article 3 of the SCM and the Illustrative List in Annex I thereto as it provides guidance for export subsidies as used in Article 10.1 of the Agreement on Agriculture. See para. 5.154.