9

US – Export Restraints
United States – Measures Treating Export Restraints as Subsidies*

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1 Introduction

This study examines the dispute brought before the World Trade Organization (WTO) concerning the *United States – Measures Treating Export Restraints as Subsidies* (WT/DS 194), euphemistically referred to herein as *US – Export Restraints*. In this dispute, Canada challenged the US treatment of export restraints under US countervailing duty law and practice. The principal legal focus was therefore on the WTO Subsidies and Countervailing Measures (SCM) Agreement. This is one of a handful of WTO cases where the complainant (Canada) was not challenging the application of a governmental measure (by the US here) but rather the WTO consistency of existing legal measures. Essentially, Canada claimed that certain US legislation along with established practice by the US Department of Commerce constitute a violation of US obligations under the SCM Agreement.

The GATT has long recognized that subsidies can serve as a non-tariff barrier to international trade. Export subsidies were targeted as an early priority. Establishing more robust rules to cover subsidies became a priority during the Tokyo Round of multilateral trade negotiations and resulted in the 1979 Subsidies Code, which like other GATT codes only applied to its signatories. According to many analysts, the Code had proven inadequate

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for a number of reasons – including the ability of parties to engage in forum shopping between the Code and Article VI – and the negotiation of a more comprehensive set of disciplines covering subsidies and the application of countervailing duties remained a priority during the Uruguay Round. Agreement on the definition of a subsidy was one of a number of highly contentious features of the negotiations.

The discussion that follows undertakes a three-step analysis. In these three steps we seek to distinguish different levels of economic and legal analysis, beginning with the most general and turning in sequence to the more specific legal and economic issues raised by the *US – Export Restraints* dispute. First, we consider the economic basis for the WTO provisions at the heart of this dispute. More specifically we ask: What are the underlying goals of the various WTO provisions touched upon in the *US – Exports Restraints* 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 that seem particularly important to understanding its legal and economic logic. We ask: Have the reviewing Panels and the Appellate Body (AB) applied the law consistently and 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. Here, 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?

2 General economic analysis

The *US – Export Restraints* case raises several levels of questions from an economic perspective. Here, we first consider the question: What are the goals of the various WTO provisions touched upon in this case, and are the goals themselves sensible from an economic perspective? A second-level question is the following: 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

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question will be taken up in section 4, after the legal aspects of the case have been fully presented and evaluated in section 3.

What, then, are the goals of the various WTO provisions touched upon in this case? The case centers on the question of whether export restraints can qualify as subsidies within the definition of a subsidy provided in the SCM Agreement. Given the fundamental nature of this question, all the provisions of the SCM Agreement are potentially affected by its resolution.

According to the panel in *Brazil – Aircraft*, ". . . the object and purpose of the SCM Agreement is to impose multilateral disciplines on subsidies which distort international trade." In broad terms, the SCM Agreement attempts to accomplish this by: defining the notion of a subsidy and drawing a distinction between a general subsidy and a subsidy which is "specific" (Part I);[1] prohibiting certain kinds of specific subsidies (Part II); requiring that most other kinds of specific subsidies, while not prohibited, must be maintained in a manner that does not cause adverse effects to any other WTO member (Part III); and spelling out the procedures for imposing countervailing duties (Part V).[2]

As this broad description indicates, the SCM Agreement consists of a complex and varied set of provisions, and a systematic evaluation of the economic logic of this Agreement is far beyond the scope of this paper. Nevertheless, we may make a number of general observations about the economic logic of these provisions.

2.1 Part II of the SCM Agreement

Article 3 of Part II of the SCM Agreement prohibits two kinds of subsidies. Export subsidies are prohibited in 3.1(a), while subsidies contingent upon the use of domestic over imported goods are prohibited in 3.1(b). As we discuss below, the economic basis for 3.1(a) is difficult to articulate, while the economic basis for 3.1(b) can be given a relatively straightforward interpretation.

[1] As noted in the Introduction, agreement on the very definition of a subsidy was a challenging feature of the negotiations, and the resulting definition requires a financial contribution and a benefit conferred thereby.

[2] As a provisional measure (now no longer in force), Part IV of the SCM Agreement permitted a third kind of subsidy to be maintained even when the subsidy does cause adverse effects to another WTO member. Except in special circumstances, Part IV disallowed the use of remedies covered in the SCM Agreement against these subsidies.

2.1.1 Article 3.1(a)

The prohibition of export subsidies contained in Article 3.1(a) serves to complement and clarify the treatment of export subsidies in section B of Article XVI GATT. The rationale for limiting export subsidies is 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, the conditions that would give rise to *importing* governments viewing export subsidies in this way are not obvious.[3]

In our companion essay in this volume on *Canada – Dairy*, we evaluate in some detail the underlying logic in the GATT/WTO on export subsidies. We shall not repeat that discussion in total herein. However, the essential point of that discussion is that, for export subsidies to actually harm an importing government, economic arguments indicate that the importing government would have to (a) be concerned about the injury to domestic producers caused by the increased exports resulting from the foreign subsidy, *and* (b) lack the ability to use tariffs or other policy instruments to respond to this injury.

As the discussion of exporter versus importer interests in section 2.1 of our companion essay on *Canada – Dairy* explains, 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. Moreover, from a worldwide perspective, it can be argued that governments that choose to subsidize their exporters in the absence of international agreements should be encouraged to subsidize *more* under international agreements, not less. 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.[4]

[3] See Bagwell and Staiger (2002), chapter 10.

[4] See ibid. 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 fundamental 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, it may be concluded that such agreements appear to run counter to the essential purpose of international trade agreements. Any economic argument in support of international agreements to restrict export subsidies must overcome this basic dilemma.

We have offered two interpretations of this conclusion in our companion essay on *Canada – Dairy*. 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 can play in limiting export subsidies. 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. For example, it is 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 adopted in order to limit export subsidies can play.[5]

A second interpretation would place more weight on the presumptions implied by the standard economic arguments. This second interpretation casts doubt on the rationale for international agreements to limit export subsidies. At the least, this conclusion 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.

2.1.2 Article 3.1(b)

The prohibition of subsidies for the use of domestic over imported goods contained in Article 3.1(b) can be given a fairly straightforward

[5] For a recent review of the commitment approach to the study of trade agreements, see Bagwell and Staiger (2002, chapter 2).

interpretation in economic terms. Such subsidies can be shown to be equivalent in economic terms to a direct subsidy for the production of the domestic good. Hence, the prohibition of the subsidies described in 3.1(b) can be seen to close a "loophole" that might otherwise exist for getting around the disciplines on production subsidies contained in Part III of the SCM Agreement.

To see the logic underlying the claim that a subsidy for the use of a domestic over an imported good is economically equivalent to a production subsidy for the domestic good, let us suppose that domestic users of good y must pay the price charged by foreign exporters, p^*, to use an imported good, and must pay the price charged by domestic producers, p, to use the domestic good. However, owing to the subsidy for use of the domestic over the imported good, which we denote in ad valorem terms as s, the effective price to domestic users of buying the domestic good – net of the subsidy payment they receive – is $p(1 - s)$. As long as the subsidy program is not so generous as to wipe out altogether the use of the imported good in the domestic economy, the domestic users must be indifferent between using the imported good at price p^* and using the domestic good at the effective price $p(1 - s)$. Assuming that these goods are "perfectly substitutable" in their intended use, we then have as an implication of this indifference the arbitrage condition that $p(1 - s) = p^*$, or equivalently $p = p^*/(1 - s)$.

Let us now suppose that the domestic economy is "small" on world markets, so that from this economy's perspective p^* is effectively fixed.[6] The first expression derived above, $p(1 - s) = p^*$, indicates that the users of good y in the domestic economy will face a user cost for this good which is tied down by p^*, and is therefore unaffected by the subsidy program. The second (equivalent) expression derived above, $p = p^*/(1 - s)$, indicates that domestic producers of good y will enjoy a higher price for their product as a result of the subsidy program (i.e. when $s > 0$). In this way, the effect of the subsidy program just described is equivalent to a direct production subsidy paid to domestic producers of good y. This equivalence follows, because such a direct production subsidy program would have the effect of raising the subsidy-inclusive price received by domestic producers of good y while leaving the price paid by domestic users of good y to be determined by the competitive conditions of foreign exporters (i.e. p^*) and therefore unaffected. As a consequence, a production

[6] The argument presented above is simplified by the "small country" assumption, but the point extends as well to the "large country" case.

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subsidy rate could then be chosen to exactly replicate the economic effects of a subsidy for the use of a domestic over an imported good.

By this logic, it may be argued that the prohibition contained in Article 3.1(b) helps to make more comprehensive the disciplines on production subsidies contained in Part III of the SCM Agreement.

2.2 Part III of the SCM Agreement

Simple economic principles raise a basic question about the internal consistency of provisions that give governments the right to challenge specific subsidies under Part III of the SCM Agreement and the coexisting fundamental right of WTO members to maintain tariffs at their bound levels. The point is, the economic effects of any particular (non-prohibitive) tariff on any particular import good y can be exactly replicated by removing the tariff and replacing it with the dual policies of (i) a tax on domestic consumption of good y, and (ii) a subsidy to domestic production of good y, both applied at the same rate as the tariff. As we explain below, this basic equivalence between different combinations of policy instruments gives rise to the possibility that the right to take actions under Part III of the SCM Agreement can interfere with the ability of tariff bindings to serve as the instrument by which governments make market access commitments.

The observation that a tariff is equivalent to a combined policy of consumption tax/production subsidy can be understood intuitively as follows. If an importer of a product must pay an import tariff on that product, then the importer's costs of acquiring that product and delivering it to domestic consumers will typically rise, and a competitive importer will have to pass the added costs of doing business on to domestic consumers in the form of a higher domestic price for the imported good. If there is a competing domestic product that is similar to the imported good in the eyes of domestic consumers, then domestic consumers will tend to shift their purchases toward this domestic product in response to the rising price of the imported good, and this consumer response will in turn tend to raise the price that domestic producers of the import-competing product receive.

The upshot, then, is that the imposition of an import tariff on y has two effects on the prices prevailing in the domestic economy: (i) it raises the price paid by domestic consumers for the imported good y and for the domestically produced "versions" of y; and (ii) it raises the price received by domestic producers who produce versions of y. The first effect is identical to the effect of a consumption tax placed on domestic consumers

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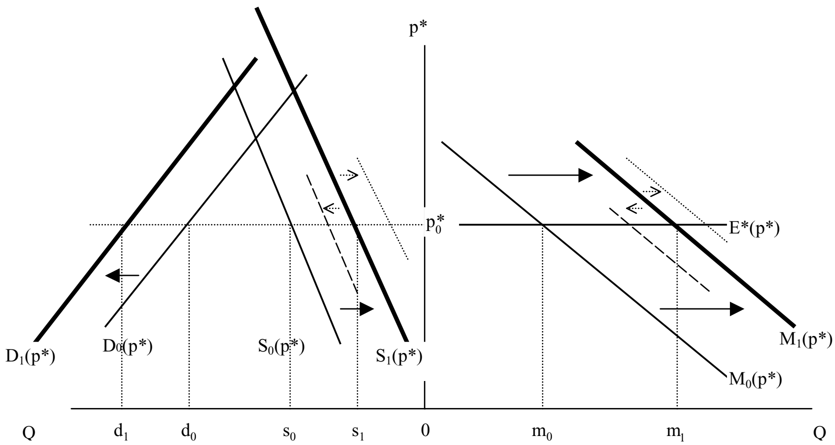

Figure 9.1

who consume y (in any of its versions, imported or domestic). The second effect is identical to the effect of a production subsidy paid to domestic producers who produce (any version of) y.[7]

2.2.1 Subsidies and the relationship between tariff bindings and market access

This basic link between tariffs and production subsidies raises an important question for the GATT/WTO, because the treatment of subsidies is evidently a critical ingredient in determining the nature of the relationship between negotiated tariff bindings and the implied market access. We may illustrate this with the use of figure 9.1.

Let us consider a country that imports good y. Let us suppose further that this country offers domestic producers of good y an ad valorem subsidy r, and applies an unbound tariff T to imports of good y from abroad. In the right-hand quadrant of figure 9.1, the foreign exporter price of good y, denoted p*, is measured on the vertical axis while the quantity of good y is measured on the horizontal axis. The downward sloping curve labeled M_0(p*) depicts the domestic country's import demand for good y

[7] A final question concerns what is to be done with the tax revenue collected as a result of the consumption tax, and the tax revenue needed to fund the production subsidy. If the production subsidy is funded by the tax revenue collected under the consumption tax, there will be an amount of tax revenue left over after the production subsidy has been funded which will be exactly the amount that would be collected as tariff revenue under the equivalent tariff.

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as a function of the foreign exporter price, p^*, given the domestic tariff and subsidy policies T and r, respectively. The horizontal line labeled $E^*(p^*)$ depicts the export supply of good y from the foreign country as a function of the foreign exporter price p^*.[8] The implied import volume and foreign exporter price at the tariff and subsidy policies T and r are depicted in the right-hand quadrant of figure 9.1 as m_0 and p_0^*, respectively.

In the left-hand quadrant of figure 9.1, the foreign exporter 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 9.1 depicts the underlying demand and supply curves for good y in the domestic economy. The domestic demand curve is labeled $D_0(p^*)$, because domestic demand for good y is a (decreasing) function of the domestic price of good y, which we denote by p, and the domestic and foreign exporter price of y are related through the tariff T by the arbitrage condition $p = (1 + T)p^*$.

Hence, for a given T, an increase in p^* implies by the arbitrage condition a proportional increase in p, allowing domestic demand to therefore be written as $D_0(p^*)$. The domestic supply curve is labeled $S_0(p^*)$, because domestic supply for good y is an (increasing) function of p (and hence of p^*, given T), and also depends (positively) on the production subsidy level r. Given the tariff T and production subsidy r, the positions of the domestic demand and supply curves are pinned down in the left-hand quadrant of figure 9.1, and at the foreign exporter price of ${p^*}_0$, they determine the domestic quantity of good y demanded (labeled d_0) and supplied (labeled s_0), whose difference corresponds to m_0.

Suppose, now, that the domestic country binds its tariff in a GATT/WTO negotiation at the level t where $t < T$. Figure 9.1 depicts the implications of this tariff binding with the bold curves. In the left-hand quadrant of figure 9.1, the domestic demand curve shifts out to the curve labeled $D_1(p^*)$ while the domestic supply curve shifts back to the curve labeled $S_1(p^*)$. Intuitively, as we have observed above, a tariff is equivalent to a consumption tax and production subsidy, and so cutting a tariff is equivalent to cutting a consumption tax (which would shift the domestic demand curve out) and cutting a production subsidy (which would shift the domestic supply curve back). In the right-hand quadrant of figure 9.1, the domestic country's import demand curve shifts out to the

[8] 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.

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curve labeled $M_1(p^*)$, reflecting the shifts in domestic demand and supply just described. At the (unchanged) foreign exporter price, the domestic country's tariff binding results in an expansion of the quantity of good y demanded in the domestic country to d_1, a contraction of the quantity of good y supplied by the domestic country to s_1, and a consequent expansion of import volume to m_1.

As figure 9.1 illustrates, the act of binding a tariff implies an offer of market access to foreign exporters, where market access is understood to reflect the competitive relationship between imported and domestic products. In terms of figure 9.1, this competitive relationship is embodied in the position of the domestic country's import demand curve, and so the offer of additional market access is captured in the right-hand quadrant by the outward shift of the domestic country's import demand curve induced by the bound tariff reduction. At a most basic level, the relationship between tariff bindings and market access rests at the heart of GATT/WTO operations. At the same time, we have observed above that there is a basic link between the economic effects of tariffs and production subsidies, and figure 9.1 suggests that the treatment of subsidies will be a critical ingredient in determining the nature of the relationship between negotiated tariff bindings and the implied market access.

We next illustrate with figure 9.1 how the right to take actions against production subsidies under Part III of the SCM Agreement can have important consequences for the ability of tariff bindings to serve as the instrument by which governments make market access commitments. We consider a first example in which this right can help to strengthen – by which we mean tighten or maintain – the relationship between tariff bindings and market access, and we consider next a second example in which this right can weaken – by which we mean loosen or disrupt – the relationship between tariff bindings and market access. We then identify an operational distinction between these two examples, and suggest that economic arguments could support introducing such a distinction into Part III of the SCM Agreement.

2.2.2 Challenging a "new" subsidy under Part III of the SCM Agreement

Consider, then, a first example in which, subsequent to binding its tariff at the level t in a GATT/WTO negotiation, the domestic country introduces a new production subsidy on good y at a rate R where $R > r$. In the left-hand quadrant of figure 9.1, the higher production subsidy rate R will shift the domestic supply curve out from the bold curve labeled $S_1(p^*)$ to

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the dashed curve. In the right-hand quadrant of figure 9.1, the implied reduction in market access is captured by the inward shift of the domestic country's import demand curve, from the bold curve labeled $M_1(p^*)$ to the dashed curve. Evidently, as reflected by the inward shift of the domestic import demand curve, the introduction of this new production subsidy has in effect reduced the level of market access from the level that was implied by the tariff binding at t given the original production subsidy level r.

If the exporting country which negotiated the tariff binding with the domestic country is unable to seek redress for the loss of market access implied by the introduction of this new subsidy, then the value of the tariff binding as a means to secure market access is diminished. This diminished value arises because the foreign exporting country has no means of preventing the market access implied by a domestic tariff reduction from being systematically offset by subsequent increases in the domestic production subsidy. And as a consequence, governments are less likely to see negotiated tariff bindings as a meaningful way to secure access to foreign markets for their exporters.

We may conclude that the relationship between tariff bindings and market access would be strengthened – that is, tightened – and the value of tariff bindings as a means to secure market access would be thereby enhanced, if it were possible to challenge the introduction of the new production subsidy in this circumstance. It might therefore be said that, by providing an avenue for this possibility, the right given in Part III of the SCM Agreement can serve to strengthen the relationship between tariff bindings and market access in this circumstance.

2.2.3 Challenging an "existing" subsidy under Part III of the SCM Agreement

Consider next a second example in which, subsequent to binding its tariff at the level t in a GATT/WTO negotiation, the domestic country is confronted with a challenge to its existing production subsidy r under Part III of the SCM Agreement. Assuming this challenge is successful, the domestic country must eliminate the production subsidy (i.e. set $r = 0$). In the left-hand quadrant of figure 9.1, the elimination of the production subsidy r will shift the domestic supply curve back from the bold curve labeled $S_1(p^*)$ to the dotted curve. In the right-hand quadrant of figure 9.1, the implied increase in market access is captured by the outward shift of the domestic country's import demand curve, from the bold curve labeled $M_1(p^*)$ to the dotted curve. Evidently, as reflected by the outward shift of the domestic import demand curve, the successful challenge to the domestic country's existing production subsidy has in effect increased the level of market access from the level that was implied by the tariff binding at t given the original production subsidy level r.

In this circumstance, it can be argued that the value of the tariff binding as a means to secure market access is diminished by the right to challenge the existing production subsidy under Part III of the SCM Agreement. This diminished value arises because the domestic importing country has no means of preventing the market access implied by a bound domestic tariff reduction from being systematically augmented by subsequent legal challenges to its domestic production subsidy. And as a consequence, governments are less likely to see negotiated tariff bindings as an acceptable way to offer foreign exporters access to their markets.

We may conclude that the relationship between tariff bindings and market access is weakened – that is, loosened – and the value of tariff bindings as a means to secure market access is thereby diminished, when the existing production subsidy in this circumstance can be challenged. It might therefore be said that the right given in Part III of the SCM Agreement can serve to weaken the relationship between tariff bindings and market access in this circumstance.

2.2.4 Part III of the SCM Agreement and the relationship between tariff bindings and market access

We may now identify an operational distinction between these two examples. In the first example, it was a new subsidy that was challenged under Part III of the SCM Agreement. In the second example, it was a subsidy that existed at the time of the tariff binding that was challenged under Part III of the SCM Agreement. The logic we have described above supports the position that a distinction between "new" and "existing" subsidies could be usefully introduced into Part III of the SCM Agreement, and that only the former should be considered actionable.

In fact, this position could be interpreted as a statement that economic arguments would support the elimination of Part III of the SCM Agreement and a return to the use of "non-violation" nullification-or-impairment claims against domestic subsidies. In this regard, the first example represents a circumstance in which Article XXIII.1(b) GATT could be used to invoke such a claim. The second example represents a circumstance in which claims under Article XXIII.1(b) GATT would not apply, because such claims would fail the requirement that the production subsidy could not have been reasonably anticipated by the exporting country at the time of the negotiation of the original tariff binding.

2.2.5 Agreements to limit subsidies and "efficient" trade agreements

Thus far we have emphasized that the treatment of subsidies will be a critical ingredient in determining the nature of the relationship between negotiated tariff bindings and the implied market access, and have evaluated Part III of the SCM Agreement from this perspective. A more complete economic analysis might characterize the efficient design of international agreements when governments make choices over both tariffs and subsidies.[9] In such an analysis, a key question is whether agreements to limit subsidies (along the lines of Part III of the SCM Agreement) would be part of this characterization. As it turns out, the answer is generally "No": it can be argued that an agreement to limit subsidies is generally not part of an efficient overall international agreement.[10] Hence, under this more complete economic analysis, the economic case against a provision such as Part III of the SCM Agreement is even stronger.

Intuitively, the reason is that, when government policy choices are extended beyond tariffs to include subsidies as well, the standard economic rationale for the purpose of international negotiations continues to take a simple form: trade volumes are inefficiently low when governments set their (subsidy and trade) policies unilaterally. As a consequence, from this perspective, the central task of international negotiations is to expand trade volumes beyond their unilateral levels to more efficient levels. This task can be accomplished through negotiated tariff bindings alone, leaving subsidies to be determined unilaterally by each country, provided that something like Article XXIII.1(b) GATT is in place to prevent the introduction of new subsidies from offsetting the market access implied by tariff bindings. Moreover, any limits placed on the permissible levels of subsidies by an international agreement would tend to reduce efficiency directly, for the simple reason that subsidies can often (in fact, according to the "targeting principle," almost always) achieve a given government objective more efficiently than tariffs, and so placing limits on subsidies in this context simply restricts governments to a less efficient set of policy instruments.

[9] Efficiency in this instance would be measured relative to the objectives of the WTO Member governments as those objectives are represented at the WTO bargaining table.

[10] See Bagwell and Staiger (in process).

2.2.6 Interpretation

As was the case with the treatment of export subsidies in Article 3.1(a), the observation made here regarding the treatment of subsidies in Part III of the SCM Agreement invites at least two possible interpretations. 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 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 subsidies that the standard models have failed to capture.

For example, as we mentioned in the context of export subsidies, it is 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 subsidies can play. In any event, under this first interpretation, the wisdom of GATT/WTO efforts to restrain the use of subsidies is not really in doubt. A second interpretation would place more weight on the presumptions implied by the standard economic arguments reviewed above, and this second interpretation casts doubt over the rationale for international agreements to limit subsidies.

2.3 Part V of the SCM Agreement

As we observed in section 2.1.1 above, countervailing duties represent one way that an importing government can respond to foreign exports that are subsidized. But among the various options for response that the importing government might consider under GATT/WTO rules, countervailing duties are exceptional in that they (i) are discriminatory and (ii) imply no compensation/retaliation rights for the exporting/subsidizing government. Here we simply observe that the discriminatory nature of the countervailing duty response might be supported with economic arguments on the grounds that, as a feature of the underlying preferences of the citizens represented by their governments at the WTO, subsidized exports are considered "unfair." However, the lack of compensation/retaliation rights for the exporting/subsidizing government is more difficult to support with economic arguments, due to the incentives for "over-utilization" that this feature of countervailing duty law creates. We develop these observations further in the related context of anti-dumping duties in our companion essay in this volume on *EC – Bed Linen.*[11]

2.4 Summary

More broadly, the point is that the SCM Agreement is, as it was described above, an attempt to ". . . impose multilateral disciplines on subsidies which distort international trade," and some (though not all) of these disciplines admit a natural economic efficiency-enhancing interpretation. As noted previously, the fundamental inefficiency associated with unilateral policy choices is insufficient trade volume. To the extent that the provisions of the SCM Agreement operate to reduce export subsidies and, ultimately, export volumes, they tend to work against efficiency. Moreover, to the extent that the provisions of the SCM Agreement create ambiguity about the market access implications of tariff commitments and thereby interfere with the ability to negotiate greater market access, they tend to work against efficiency.

On the other hand, to the extent that the provisions of the SCM Agreement provide disciplines on the use of (new) subsidies that help governments negotiate more effective market access agreements through tariff commitments and achieve greater trade volumes, then these provisions may be interpreted as contributing to efficiency from an economic perspective.

3 Facts of the case and legal issues before the panel

3.1 Introduction.

As noted in the introduction, this dispute between the United States and Canada has to do with the treatment of export restraints under US

[11] A distinction between anti-dumping duties and countervailing duties in the context of the potential desirability of compensation/retaliation rights is that there does not exist an agreement within the GATT/WTO to limit dumping, whereas with regard to subsidies the SCM Agreement represents just such an agreement. It might then be argued that countervailing duties can play a useful role in restricting the use of subsidies, and thereby can be seen as helping to enforce the provisions of the SCM Agreement, and that the idea of permitting such actions to lead to compensation/retaliation rights by the affected exporting governments would work against this enforcement purpose. However, against this reasoning it can be argued that the SCM Agreement already provides for remedies in the case of violations of the Agreement, and that countervailing duty actions can therefore be logically separated from enforcement actions for the purposes of considering the potential desirability of the addition of compensation/retaliation rights.

countervailing duty law and practice.[12] The US, as a preliminary matter, requested the case to be dismissed because the measures at issue were discretionary and therefore did not oblige WTO inconsistent action, which was nevertheless not applied in this case. Canada argued that the US measures *obliged* the US to treat export restraints as a "financial contribution" under the SCM Agreement Article 1.1, which interpretation is inconsistent with the subsidies agreement. We shall come back to this question of sequencing, which we believe had significant implications for the resolution of the case.

The specific US measures at issue included: (1) section 771 (5) of the Tariff Act of 1930; (2) the Statement of Administrative Action (SAA) which accompanied the Uruguay Round Agreements Act; (3) the US Department of Commerce's (DOC) Explanation concerning the CVD Final Rules and (4) the US "practice" concerning the treatment of export restraints.

The mandatory/discretionary nature of the US measures is an important part of this case. However, we first focus on the substantive question of whether export restraints can constitute a subsidy and then turn to the question of whether the US measures require the DOC to treat export restraints as subsidies.

3.2 The purpose of the SCM Agreement and the treatment of export restraints under the SCM: is this a financial contribution?

As we see below, under Article 1.1 of the SCM Agreement, the definition of a subsidy has two elements: (1) a financial contribution, which can be provided through various means as specified in four sub-paragraphs, (2) which thereby confers a benefit.

Article 1.1 of the SCM Agreement defines a subsidy as follows:

> A. 1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:
>
> (a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e., where:
>
> (i) a government practice involves a direct transfer of funds (e.g., grants, loans and equity infusion), potential direct transfers of funds or liabilities (e.g., loan guarantees);

[12] Specific provisions invoked included Articles 1.1, 10, 11, 17, 19, and 32.1. Canada also invoked certain other provisions of the SCM Agreement and the WTO, which the Panel did not address, such as Article XVI.4 and Article 32.5 of the SCM Agreement.

(ii) government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits);

(iii) a government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;

or

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994; and

(b) a benefit is thereby conferred.

The key specific issue in this dispute was whether export restraints can constitute a "financial contribution" and whether the US treatment of export restraints under its measures is consistent with the SCM Agreement. The parties agreed that an export restraint could confer a benefit hence the Panel focused solely on the question of whether an export restraint could constitute a "financial contribution."

The SCM Agreement itself does not define the term export restraint nor does it specifically clarify whether and under what circumstances it could be deemed to constitute a financial contribution. The parties disagreed on both dimensions. Canada defined an export restraint as "a border measure that takes the form of a government law or regulation which expressly limits the quantity of exports or places explicit conditions on the circumstances under which exports are permitted. Such measures could also take the form of a government-imposed fee or tax on exports of the product calculated to limit the quantity of exports."[13]

The United States took a broader view to encompass "any action or an act that holds back or prevents exports." The US also argued that it was neither practicable nor desirable for the panel to come up with a new definition of an export restraint since the SCM Agreement itself did not define the term. The Panel agreed with this latter view and chose to go with the definition as proposed by the United States rather than attempting to define an export restraint anew.

In the US view, an export restraint can constitute a financial contribution within the meaning of SCM Agreement 1.1(a)(1) since a limitation or prohibition of exports could be functionally equivalent to an entrustment

[13] See para. 8.16.

of or direction to a private body to provide goods domestically.[14] In Canada's view, however, the government must explicitly and affirmatively instruct the private entity to provide the goods in order to come under the SCM Agreement, Article 1.1(a)(1)(iii) and (iv). An export restraint as such, Canada argued, does not authoritatively instruct or commission producers of the restrained good to do anything; instead it limits their ability to export.[15] Hence, in the Canadian view, an export restraint cannot satisfy the definitional standard under Article 1 of the SCM Agreement.

3.3 The Panel's interpretation of the SCM Agreement

The Panel held that the SCM Agreement's use of the term "entrustment" or "direction" in subparagraph iv of Article 1.1 refers to a situation where the government is executing a particular policy by operating through a private body. Further, it says that the action of the government must therefore be an explicit and affirmative act, be it through delegation or command; addressed to a particular party, and the object of which is a particular duty.[16] All three of these elements must be present in order for the act of either "entrustment" or "direction" to have occurred. In this way, an explicit and affirmative action of delegation or command is deemed to be critical.

As a result, the Panel found the US approach that centers on the "effect" of an export restraint to be overbroad, and potentially resulting in a determination that any government measure that had the effect or caused an increase in the domestic supply of a good would constitute a government entrusted or directed provision of goods and hence a financial contribution (8.36). It noted and analogized from the reasoning of the Appellate Body in *Canada – Aircraft Credits and Guarantees* that "the focus of the SCM Agreement's obligations is on the granting government." Here, for the "entrusts and directs" standard to be met, i.e. for there to be a financial contribution in the sense of sub-paragraph (iv), the government action must be the focus, rather than the possible effects of the action on, or the reactions to it by those affected, even if those effects or reactions are expected.[17] The SCM Agreement, the Panel argued, was concerned

[14] See para. 8.22. [15] See para. 8.26. [16] See para. 8.29–8.30.

[17] See para. 8.42. Another issue between the parties had to do with the definition of "private body" as used in Article 1.1(a)(1)(iv). On this point, the Panel held that the term was a counterpoint to "government" or "public body" and hence any entity that is neither a government nor a public body would be a private body.

about subsidies as *defined* in the agreement, which includes the notions of financial contribution, benefit, and specificity.

To further clarify and amplify this point, the Panel undertook an examination of the negotiating history of the inclusion of the "financial contribution" requirement in the Agreement. This negotiating history contained a longstanding difference between the United States and Canada as to the extent to which the existence of a benefit conferred by any government could be considered a subsidy that is subject to countervailing measures. The Panel concluded that the definition that was ultimately arrived at during the negotiations rejected the US approach of defining subsidies as a benefit resulting from any government action by requiring that the government action be a financial contribution, as set out in an exhaustive list.[18] In a word, the Panel found that the negotiating history of a subsidy, which required both a financial contribution and a benefit, limited the countervailability of benefits from any sort of government measures to a finite list of measures that would, if they confer benefits, constitute subsidies.

For these reasons, the Panel concluded that an export restraint as defined by Canada in the dispute cannot constitute government entrusted or directed provision of goods in the sense of sub-paragraph (iv) and there was not a financial contribution in the sense of Article 1.1(1) of the SCM Agreement.[19]

3.4 *Mandatory versus discretionary actions*

The US had requested that the claims be dismissed in that the US legislation, as well as the practice at issue, were discretionary in nature and do not *require* the US to treat export restraints as subsidies. Absent such a requirement, the mere discretionary authority to interpret export restraints as subsidies would not be actionable as a violation of the WTO.[20]

[18] See para. 8.69.

[19] The panel went to some pains to reiterate that it was only referring to the definition of an export restraint as used by Canada and it was not making any judgment as to the WTO consistency of any other measures that Members may label export restraints or that fall outside the bounds of the Canadian definition. See para. 8.76.

[20] The US also raised certain other procedural claims that it believed should result in a dismissal of claims. For example, the US claimed that the DOC "practice" with respect to its interpretation of the applicable US rules does not constitute a governmental measure and therefore should not be a matter for review by the dispute settlement panel. See para. 4.1, 4.17 and 8.1.

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Canada agreed that no violation could be found if the measures at issue were discretionary. However, Canada argued that even if the statute was discretionary, section 771(5) as "interpreted by" the Statement of Administrative Action and the Preamble constitute mandatory legislation that require the Department of Commerce to violate its obligations under the SCM and further that the Statement and preamble "curtail the discretion" of the Department of Commerce to act in a WTO-consistent fashion.

The Panel rejected the US request to dismiss the case. It argued that the issue of whether the measures are mandatory or discretionary "goes to the substance."[21] It relied on certain GATT/WTO precedent for the proposition that "only legislation that *mandates* a violation of a WTO/GATT obligation can be found as such to be inconsistent with those obligations."[22] Discretionary legislation, on the other hand, cannot be challenged, only its specific application. This was identified as the "classical test," and one agreed by the parties to be applicable in this case.

The Panel decided to apply the classical test to this dispute[23] to help determine whether the US law is mandatory with respect to the treatment of export restraints as "financial contributions" in the countervailing duty investigation. By choosing to apply the classical test, the Panel stated that this had "longstanding historical support" that had been recently employed by the Appellate Body.[24] Further, that it served a rational objective in ensuring "predictability of conditions for trade" in that parties will know to challenge legislation that will "necessarily result in action inconsistent with GATT/WTO obligations, before such action is actually taken."[25] These issues are considered more directly in section 3.7 below.

3.5 US measures

In making its determination whether US law requires that export restraints be treated as financial contributions, the Panel looked at the language of the US measures and analyzed each of the US measures separately to determine whether any or all of the measures had a functional life of its own[26] as well as whether "taken together" they had a required character. We turn now to briefly review the challenged US measures.

[21] See para. 8.2. [22] See para. 8.4.
[23] With respect to this classical test, the panel cited the Appellate Body language in *US – 1916 Act* as well as the GATT Panel Report in US – Tobacco. See paras 8.3–8.6.
[24] See para. 8.9. [25] See para. 8.9. [26] See para. 8.85.

Section 771 (5). The Panel also examined the legislative history of pre and post WTO US law. It noted that the relevant provisions of US law as to what constitutes a subsidy (section 771(5)(D)), which in turn requires a financial contribution and the conferring of a benefit, essentially mirror the language of the SCM Agreement. The statute does not explicitly address export restraints. The Panel argued that the statute read in "isolation therefore reveals nothing about the treatment of export restraints under US countervailing duty law and could not be said to require any particular treatment of export restraints."[27]

The Statement of Administrative Action. The Panel then evaluated the Statement of Administrative Action. The Panel underscored the view articulated by Congress and reflected in the Statement itself that this is an authoritative expression of the Administration's views regarding the interpretation of the Uruguay Round Agreements and a source of primary interpretative guidance. The Panel did not see the Statement as having an operational life independent of the Uruguay Round Agreements Act (URAA). It did not see that it could, on its own, give rise to a violation of WTO rules.[28]

As to whether the Statement of Administrative Action requires the Department of Commerce to interpret the statutes such that export restraints are treated as financial contributions, the Panel noted that the statute is silent on the question of export restraints as such. On the question of its interpretive guidance on this question, the Statement offers conflicting commentary. It references certain past Department of Commerce cases where the Department treated export restraints as countervailable subsidies when they confer a benefit and are specific. Some portions of the Statement state that this practice will continue. Other portions suggest that this will be followed only under the new definition of a subsidy, referring to the requirement that there be a "financial contribution." It states that where the Department of Commerce is satisfied that the standard under section 771(5)(B)(iii) and Article 1.1(a)(1)(iv) of the SCM Agreement is satisfied, it will continue to countervail.[29]

Specifically, these different strands are evident in the section of the Statement of Administrative Action that discusses where a government entrusts or directs a private entity to make a financial contribution, which states:

[27] See para. 8.92. [28] See para. 8.99. [29] See para. 8.89.

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> The Administration intends that the "entrusts or directs" standard shall be interpreted broadly. The Administration plans to continue its policy of not permitting the indirect provision of a subsidy to become a loophole when unfairly traded imports enter the US and injure a US industry. In the past, the Department of Commerce has countervailed a variety of programs where the government has provided a benefit through private parties. (See, e.g., Certain Softwood Lumber Products from Canada, Leather from Argentina, Lamb from New Zealand, Oil Country Tubular Goods from Korea, Carbon Steel Wire Rod from Spain and certain Steel Products from Korea.) . . . . . In cases where the government acts through a private party, such as in Certain Softwood Lumber Products from Canada and Leather from Argentina . . . the Administration intends that the law continue to be administered on a case by case basis consistent with the preceeding paragraph. It is the Administration's view that Article 1.1(a)(1)(iv) of the Subsidies Agreement and Section 771(5)(B)(ii) encompass indirect subsidy practices like those which Commerce has countervailed in the past, and that these types of indirect subsidies will continue to be countervailable, provided that Commerce is satisfied that the standard under Section 771(5)(B)(iii) has been met.[30]

The Panel examined these conflicting passages and concluded that while the passages suggest a "a certain tension," the Department of Commerce's past practice will be followed in the future "only to the extent that there is no inconsistency with the definition of subsidy under the URAA." In this way, the Statement does not require the Department to interpret the statute in such a manner whereby export restraints are to be treated as a "financial contribution."[31]

The Preamble. A further legal question was whether the Preamble to the US countervailing duty regulations has an independent operational life that could give rise to the violations alleged by Canada. On this point the US and Canada had differed as well, with the US claiming that only the Regulations have the force of law and Canada claiming that the Preamble is an integral part of the Regulations. The Panel examined the preambular language and concluded that it has no operational life of its own separate from the regulations. Nevertheless, the Panel held that there was no reason to exclude the Preamble from consideration as a possible interpretative tool in the treatment of export restraints in US countervailing duty investigations.

[30] See para. 2.5. [31] para. 8.103–8.106.

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On this point, the Preamble references the Statement of Administrative Action as "directing" the Department of Commerce to proceed on a case-by-case basis with respect to the definitional elements of a "subsidy" and the Preamble incorporates by reference and defers to the Statement "in respect of the interpretation of the definitional element of a subsidy, in particular the meaning of *entrusts* or *directs*."[32]

The Preamble does speak about export restraints specifically and states that they can "in certain circumstances lead those parties to provide the restrained good to domestic purchases for less than adequate remuneration. This was recognized by Commerce in *US – Softwood Lumber III* and *Argentina – Hides and Leather*. Further, as indicated by the Statement at 926 and as we confirm in these Final Regulations, if the Department were to investigate situations and facts similar to those examined in *US – Softwood Lumber* and *Argentina – Hides and Leather* in the future, the new statute would permit the Department of Commerce to reach the same result."[33]

The Panel held that this "would permit" language in the Preamble is consistent with the interpretation of the statute that the Department of Commerce is not required under US law to treat export restraints as financial contributions.[34]

US Practice. Canada also argued that the Department of Commerce "practice" was an institutional/administrative commitment to treat export restraints as financial contributions and that this is reflected in earlier cases that foreclose any discretionary consideration of the treatment of export restraints. As examples of US practice that reflected the institutional commitment to treat export restraints as financial contributions, Canada pointed to the pre-WTO practice of countervailing export restraints where they "directly led to a discernible benefit." Canada argued that this practice was explicitly referenced in the Statement of Administrative Action and the Preamble, adding further support to an interpretation that it would continue to be operative in the future. Moreover, Canada mentioned two post-WTO cases where it was alleged that the Department had indicated it would continue to take this approach in the future.[35]

The Panel disagreed and found the Canadian interpretation imprecise and not contained in any defined cases of export restraints in US countervailing duty investigations in the post-Uruguay Round context. In other words, there has been no case since the WTO came into existence in which the US has countervailed against an export restraint. The Panel

[32] See para. 8.115. [33] See para. 8.116. [34] See para. 8.111. [35] See para. 8.120–8.122.

also noted that while practice must normally be followed, it can also be departed from, so long as a reasoned explanation is provided.[36] Hence, with respect to the US government measures, the Panel found that only the statute has an independent operational life of its own, although it must be read in light of the Statement, and that the Statement is the principal interpretive guide thereto.

The Panel further argued that, when read in light of the Statement, the statute does not require the treatment of export restraints as financial contributions in countervailing duty investigations. The Preamble contributes very little substance. The Panel therefore concluded that there was insufficient clarity as to the meaning of US practice to draw a conclusion that it requires any particular treatment of export restraints. Thus, there is no mandatory treatment of export restraints as financial contributions.[37]

3.6 Decision of the Panel

In sum, the Panel concluded that: (1) an export restraint as defined in this case cannot constitute government entrusted or directed provision of goods and hence does not constitute a financial contribution in the sense of Article 1.1(a) of the SCM; (2) the contested US measures are not inconsistent with Article 1.1 of the SCM Agreement by *requiring* the application of countervailing duties against practices that are not deemed subsidies. Thus, the statute requires both a benefit and a financial contribution. Here, an export restraint was seen as conferring a benefit but was not deemed to confer a financial contribution, and hence no countervailable subsidy.

3.7 Interpretative legal and policy issues

Section 4 below evaluates the treatment of export restraints as subsidies from an economic perspective. Here, we examine the legal reasoning of the Panel with respect to several questions of law and fact that raise systemic questions.

First, was the decision to apply the so-called "classical test" consistent within WTO caselaw? Second, despite its decision that only mandatory measures matter, the panel decided to undertake a substantive analysis first and then turn to the procedural question of whether the measures

[36] See para. 8.126. [37] See para. 8.130.

were mandatory or discretionary. Was this the appropriate sequencing of claims?

On the first point, there is now a considerable body of GATT and WTO dispute settlement practice that has considered the so-called "mandatory-discretionary" question.[38] What is called the "classical test" refers to GATT precedent that only national legislation which is mandatory in its application and in a manner inconsistent with its GATT obligations can be a violation. Discretionary legislation, that is, national measures that provide the government, e.g. the executive branch, with the discretionary authority as to how to act or indeed whether to act, and therefore provide the scope for acting inconsistently with a GATT/WTO obligation are not viewed as a prima facie violation of the WTO. It is possible for discretionary legislation to be inconsistent with a covered agreement and thereby constitute a violation thereof, but that requires its WTO inconsistent *application*. In the GATT context, with this distinction came the view that only mandatory measures could alter the competitive opportunities of international trade.[39]

The majority of WTO case law has followed this basic precedent as in the case of *US – Export Restraints*. The Panel aligned itself with the dominant jurisprudential trend on this question. Indeed, the Panel barely took heed of the most important case that suggested that discretionary

[38] This includes at least a dozen cases: *Argentina – Measures Affecting Imports of Footwear, Textiles, Apparel and Other Items* (WT/DS56); *Canada – Measures Affecting the Export of Civilian Aircraft* (WT/DS70); *Turkey – Restrictions on Imports of Textile and Clothing Products* (WT/DS34); *US – Anti-dumping Act of 1916* (WT/DS136); *US – Anti-dumping Act of 1916* (WT/DS/162); *US – Anti-dumping Measures on Certain Hot-Rolled Steel Products from Japan* (WT/DS184); *US – Section 301–310 of the Trade Act of 1974* (WT/DS152); *Brazil – Export Financing Program for Aircraft* (WT/DS46W); *US – Section 211 Omnibus Appropriations Act of 1998* (WT/DS176); *Canada – Export Credits and Loan Guarantees for Regional Aircraft* (WT/DS222); *US – Anti-dumping and Countervailing Measures on Steel Plate from India* (WT/DS206/r); *US – Countervailing Duties on Certain Corrosion-Resistant Carbon Steel Flat Products from Germany* (WT/DS213); *US – Section 129 (c)(1) of the Uruguay Round Agreements Act* (WT/DS221); *US – Continued Dumping and Subsidy Offset Act of 2000* (WT/DS217, WT/DS 234); *US – Preliminary Determinations with Respect to Certain Softwood Lumber from Canada* (WT/DS236); *US – Countervailing Measures Concerning Certain Products from the EC* (WT/DS212).

[39] See, *US – Superfund* para. 5.2.9; *US – Malt Beverages*, para. 5.39, *US – Tobacco. US – Tobacco* has a particularly clear statement on this issue: "Panels had consistently ruled that legislation which mandated action inconsistent with the General Agreement could be challenged as such, whereas legislation which merely gave the discretion to the executive authority of a contracting party to act inconsistently with the General Agreement could not be challenged as such; only the actual application of legislation could be subject to challenge" *US – Tobacco*, Panel Report, adopted October 4, 1994, BISD 41S/131, para. 118).

legislation, namely the *US – Section 301 Trade Act* dispute, could constitute a *prima facie* violation of the WTO.[40] That case involved the timeline in section 301 of the 1974 Trade Act, as amended, which calls for retaliatory measures within eighteen months when foreign countries have been found to breach their international obligations while the DSU procedures usually take longer.

The EC alleged that the section allowed for retaliation without going through the WTO dispute settlement system, as mandated by Article 23 of the DSU. The US, for its part, argued that language in the SAA made plain that no WTO inconsistent action could be taken. The Panel held that discretionary legislation may support a violation. It stressed that its test did not overturn earlier GATT jurisprudence. The Panel argued that a rule that only legislation mandating inconsistency could violate the WTO does not mean that legislation with discretion can never be found a violation.[41] The WTO Appellate Body has considered the question of mandatory/discretionary legislation to a degree.[42] In our view, it has not entirely shut the door to the view expressed in section 301 that discretionary legislation can be a WTO violation.[43]

US – Export Restraints is a somewhat unusual case in that the complainant challenged the legislation on its face and not with respect to a particular application. We can only speculate why this case was brought in the first place. Given the track record here of past cases where the US held that export restraints *did* constitute an export subsidy, and given the existence of language in the Preamble and the SAA that suggested the ability to continue past precedent, Canada with no doubt wished to obtain a holding from a panel to pre-empt a US action. It obtained such a ruling, at least with respect to the potential application of countervailing duties on export restraints as defined by Canada.

[40] While the Panel's decision seems reasonable, the Panel's stated grounds for differentiation, namely the fact that this dispute centered on the subsidy agreement rather than the DSU and thus covered a different part of the WTO, seems perfunctory. Moreover, the Panel's argument that it was applying the classical test because the parties agreed that that should be the approach taken is also not persuasive legal argumentation.

[41] See para. 7.43.

[42] See, for example, *US – 1916 Act* where it held that the meaning of discretion had to do with the discretion vested in the executive branch of government (para. 91).

[43] In *US – Countervailing Measures on Certain EC Products*, for example, the Appelate Body emphasized that it was "not by implication precluding the possibility that a Member could violate its WTO obligations by enacting legislation granting discretion to its authorities to act in violation of its WTO obligations" (footnote 334).

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Yet, at the end of the day, the Panel concluded after a careful review of the challenged US measures that they were discretionary. Hence, the Panel's decision on sequencing of analysis allowed it to opine on whether the US treatment of export restraints is consistent or inconsistent with the SCM Agreement when arguably it was not obliged to do so. Here we are left with the impression that the Panel really wanted to evaluate the case on the merits while not being fully obliged to do so.[44]

This issue therefore raises the broader question of judicial philosophy: should the Panel have undertaken the substantive analysis or should it have been expected to terminate its inquiry having determined that the applicable US measures were discretionary in the first instance and therefore did not oblige a violation of the SCM Agreement?

Clearly this is an issue of judicial philosophy or policy where opinion will differ. One could arguably find the Panel's decision to undertake a substantive analysis (i.e. of whether a certain category of measures can constitute a financial contribution) before it has undertaken a determination on the nature of the measures as being of a speculative and abstract nature. Does this decision by the Panel overstep the authority of WTO Panels? There may not be clear answers to these questions in the rules of the WTO or the DSU.

A restrained approach to judicial interpretation may be particularly relevant with respect to legislation that is being evaluated on its face and not with respect to a particular dispute. Such a claim could be premature or overreaching because no nullification or impairment has yet occurred. In this dispute the United States asserted that the Panel was being asked

[44] The *US – Export Restraint* Panel relied on three earlier cases for its decision to tackle the substantive features before examining the nature of the challenged measures. These cases are distinguishable from *US – Export Restraints* by virtue of the relatively non-controversial nature of the legal matters in question as compared with the deeply contested legal questions arising in *US Export Restraints*. We are grateful to Professor Hudec for many of this comments on an early draft of this essay, including his observations on this point. The Panel, in para. 8.11, specifically referenced *US – SuperFund*, where the scheme involved a discriminatory penalty tax that would be imposed if certain information was not submitted. The Panel found that a penalty tax, if imposed, would violate Article II.2, and then went on to find that the Superfund Act did not require imposition of the tax, See Report of the Panel BISD 34S/136 para. 5.29; *Thailand Cigarettes*: where the GATT Panel found that certain discriminatory tax rates would violate GATT provisions, but the Panel went on to find that the Thai authorities had room to implement the rates in a consistent fashion, See BISD 37S/200 para. 84; and *US – Tobacco*, where the GATT Panel concluded that the US had discretion to interpret its legislation consistently with the GATT, see BISD 41S/131, para. 123. See para. 8.11 footnote 114.

to render an advisory opinion, which by most accounts is not within the jurisdiction of panels or the Appellate Body to grant.[45] It has surfaced in a number of disputes.[46] As a matter of practice, the current Chairman of the Appellate Body has stated plainly that "we do not render advisory opinions in the Appellate Body."[47]

A more supportive view could argue that the Panel was justified in examining the challenged measures because these practices had been sources of intergovernmental dispute in the past. Further, there was no bright line between process and substance and the Panel had to undertake a legal analysis of the US measures in order to determine whether they alone or in combination amounted to mandatory or discretionary actions.

On balance, our view is that it was possible to evaluate the discretionary or mandatory nature of the measures as a threshold matter. As a result, the Panel's decision to evaluate the merits of the claim when it was not obliged to do so was inappropriate.[48] This view does not mean, however, that the Panel's rendering amounts to an error of law. The result may be a set of declaratory statements or dicta that perhaps serve as a warning to WTO members that may be inclined to interpret their own laws in a fashion that would deem export restraints to be countervailable subsidies. It is

[45] One can draw textual support in certain DSU provisions for the proposition that the dispute settlement system is not designed to render advisory opinions. For example, Article 3 states that the dispute settlement system is aimed at securing a "positive solution to a dispute," and Article 11 states that the function of panels is to make an "objective assessment of the matter before it, including the objective assessment of the facts of the case and the applicability and conformity with the relevant covered agreements. . . ." Advisory opinions also raise issues of compliance and retaliation.

[46] By way of examples, and without speaking to the accuracy of the allegations, the assertion has arisen in at least the *EC – Bananas* dispute; *US – Byrd Amendment*, and *Korea – Dairy* Panel (WT/DS98/R).

[47] The Chairman went on to state, "we render opinions only when there are specific trade disputes." See, Bacchus (2002). It is also true that the SCM Agreement itself establishes a mechanism for obtaining advisory opinions from a committee of external experts, reflected in Articles 24.3 and 24.4 of the Agreement, and there is nothing to suggest that this function is expected from panel or Appellate Body review.

[48] A counter-argument to this position might begin from the view that the possible – even if not mandatory – use of countervailing duties against export restraints could induce exporting governments to refrain from using export restraints as long as there was significant uncertainty about the legality of such an application of countervailing duty measures. From this viewpoint, it might then be argued that the Panel was justified in evaluating the merits of the claim in order to resolve the legal uncertainty. Such an argument, while certainly reasonable, would have to be weighed against the risk of judicial over-reaching. Our view is that in this particular case the risks of the latter probably outweigh the benefits of the former.

not clear that such "guidance" from the chambers of dispute settlement panels is appropriate (though see also note 49).

4 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 whether an export restraint could ever (under any circumstances) be interpreted as conferring a subsidy within the meaning of the SCM Agreement.

Before turning to our specific economic analysis, it may be helpful to begin with a basic observation, in order to frame the subsequent discussion. As described by the Panel (paragraph 1.1), the issue under consideration is ". . . US measures that treat a restraint on exports of a product *as* a subsidy to other products made using or incorporating the restricted product if the domestic price of the restricted product is affected by the restraint" (emphasis added). As this statement indicates, at one level the issue under consideration comes down to a simple question: what other policy measure is an export restraint *most like* when it comes to the implications of the export restraint for other products? As it happens, economic arguments can give a precise analytical answer to this question.

To develop this answer, we begin by observing that basic economic arguments can be used to show that an export tax on a single export good is conceptually equivalent to (i.e. "exactly like") an alternative program in which an export subsidy of the same magnitude is placed on every other export good and an import tariff of the same magnitude is placed on each imported good.[49] Intuitively, an export tax on a good lowers the price of that good in the domestic market relative to all other domestic prices, and this induces domestic consumers to shift their consumption toward that good and away from others at the same time that it releases for use in other sectors domestic resources that were used in the production of that export good. These effects mirror the impact of the alternative program described just above.

[49] This follows from an application of Lerner's Symmetry Theorem (Lerner, [1936], pp. 308–13).

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Perhaps surprisingly, the conceptual equivalence between an export tax and the alternative program described just above continues to hold even when, for example, the export good under consideration is used as an input into the production of certain other (export- or import-competing) goods in the economy.[50] As a consequence, it would be valid to assert this equivalence in a circumstance such as that considered in the case of *Argentina – Hides and Leather*, where a government embargo on exports of cattle hides was found to be a countervailable subsidy to leather producers, and in the case of *US – Softwood Lumber*, where export restraints on logs were found to be countervailable subsidies to lumber producers. The equivalence result described above would indicate that the export restraints on cattle hides and logs would, in each case, be conceptually equivalent to an alternative program in which an export subsidy of the same magnitude is placed on every other export good and an import tariff of the same magnitude is placed on each imported good.

Recalling now the previous discussion contained in section 2.2 above, in which it was observed that an import tariff can be decomposed into its two component parts of consumption tax and production subsidy, and observing analogously that an export subsidy may be decomposed into its two component parts of a consumption tax on the export good and a production subsidy to export producers, it may be concluded that basic economic arguments can be used to show that an export tax on a single export good is conceptually equivalent to an alternative program in which a production subsidy of the same magnitude is placed on every other good in the economy and a consumption tax of the same magnitude is placed on every other good in the economy.[51]

The above statement provides a precise economic interpretation of the view that an export tax can confer a subsidy to production in other sectors of an economy. In fact, however, as the statement above reveals, if the subsidy conferred by an export tax is to be highlighted, then it is more accurate to say that the export tax confers a subsidy to production in *every* other sector of the economy. But this interpretation, while valid

[50] An extension of Lerner's Symmetry Theorem to allow for intermediate inputs can be found in McKinnon (1966). The particular result that underlies the statement made above is contained in Theorem 4 of that paper.

[51] This statement asserts that the implied production subsidy in every other sector of the economy will be at a common *ad valorem* rate, but we emphasize that from this it does not follow that production in every other sector of the economy will expand at a common rate.

from an economic perspective, carries with it a potentially important implication for the treatment of export restraints as subsidies within the SCM Agreement.

We now suggest that this interpretation provides the basis for an alternative line of reasoning by which the Panel might have rejected the US position that export restraints could ever (under any circumstances) constitute countervailable subsidies under the SCM Agreement. Under this alternative reasoning, the Panel might have argued that the US's own "effects" approach, if followed to its logical conclusion, would imply that export restraints could never constitute specific subsidies within the meaning of Article 2 of the SCM Agreement, and as a consequence would not be actionable under the SCM Agreement.

In particular, in its arguments the US suggested the validity of adopting an effects approach in determining whether a government action constitutes a financial contribution. Under this approach, the US argued that an export restraint that has the effect of inducing domestic producers to sell their product to domestic purchasers is "conceptually equivalent" to an explicit and affirmative order by the government to do so, and therefore constitutes a financial contribution in the form of a government-entrusted or government-directed provision of goods. The Panel rejected this approach, and ultimately relied on the ordinary meanings of the words "entrusts" and "directs" to conclude that an explicit and affirmative action of delegation or command is required to constitute a financial contribution under the SCM Agreement, a requirement which it concluded an export restraint cannot satisfy (para. 8.44).

In rejecting the effects approach taken by the US, the Panel observed that under this approach a tariff would constitute a subsidy within the meaning of Article 1 of the SCM Agreement, because the effects of a tariff would be conceptually equivalent to a subsidy to domestic producers of the tariff-protected product, and even though the nature of the government action associated with these two forms of government intervention would be quite different, under the US effects approach differences in the nature of government actions would be irrelevant given the equivalence of effect (para. 8.37).[52]

[52] Notice that the "tariff-as-production-subsidy" argument made by the Panel can be given a formal basis according to the tariff-as-production-subsidy-and-consumption-tax argument explained in section 2.2 above. Unlike an export tax, then, which as we have observed according to Lerner's Symmetry Theorem can be said to confer a production subsidy to every other sector of the economy, an import tariff can be said to confer a production subsidy to only the tariff-protected producers.

We suggest here that, rather than rejecting the US effects approach and relying on the ordinary meanings of the words "entrusts" and "directs" to reach its final conclusion, the Panel might have come to the same final conclusion by: (i) accepting for the sake of argument the US effects approach; (ii) arguing on the basis of the economic principles described just above that an export tax on a single export good is conceptually equivalent to an alternative program in which a production subsidy of the same magnitude is placed on every other good in the economy and a consumption tax of the same magnitude is placed on every other good in the economy; (iii) observing that the production subsidy conferred by this export restraint could not qualify as a specific subsidy within the meaning of Article 2 of the SCM Agreement; and (iv) concluding therefore that by the US's own effects-approach logic, an export restraint could never (under any circumstances) be interpreted as conferring an actionable subsidy within the meaning of the SCM Agreement.

The statement that the subsidy conferred by an export restraint applies to every other sector of the economy is admittedly counter-intuitive, especially when applied in a case such as *US – Softwood Lumber*. So it is important to be clear on what the underlying equivalence result that supports this statement says and what it does not say. Recall that the equivalence result says that an export tax on a single export good is conceptually equivalent to an alternative program in which a production subsidy of the same magnitude is placed on every other good in the economy and a consumption tax of the same magnitude is placed on every other good in the economy. Note that this result says nothing about the expected effects of these (equivalent) policies on trade volumes relative to an alternative of no intervention. So in particular, this result does *not* for example rule out the possibility that an export tax on logs would have a large expansionary impact on the volume of exports of lumber, and dispelling the belief that this result carries with it such an implication may go some way toward reducing the counter-intuitiveness of the result. Rather, the result says only that, whatever the economic effects of the export tax are, those effects will be replicated if the export tax is replaced by the dual policies described above.

5 Concluding observations on the legal tests and economic analysis

In general, we are of the view that the problematical aspects of this case do not stem from poorly drafted treaty text. There may be some areas where

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the rules could have been crafted more precisely or when they could have included some additional examples that might have answered directly some questions of interpretation. However, these drafting refinements tend not to go to the heart of the issues raised by the case. Instead, the conceptual problems discussed herein stem from the ambiguity or disjunction between the stated goals of the agreement and the instruments and approaches selected.

Turning now to the conceptual foundations of the case, we make the following broad economic observations.

First, while the SCM Agreement represents an attempt to ". . . impose multilateral disciplines on subsidies which distort international trade," we have explained in section 2 that only some of these disciplines admit a natural economic efficiency-enhancing interpretation. This finding derives from a basic observation. As we noted in that section, standard economic arguments can be utilized to succinctly characterize the fundamental inefficiency associated with unilateral policy choices in a global economy: insufficient trade volume.

This basic observation underlies the following three broad conclusions. First, to the extent that the provisions of the SCM Agreement operate to reduce export subsidies and, ultimately, export volumes, they therefore tend to work against efficiency. Second, to the extent that the provisions of the SCM Agreement create ambiguity about the market-access implications of tariff commitments and thereby interfere with the ability to negotiate greater market access, they again tend to work against efficiency. And third, to the extent that the provisions of the SCM Agreement provide disciplines on the use of (new) subsidies that help governments negotiate more effective market access agreements through tariff commitments and achieve greater trade volumes, then these provisions may be interpreted as contributing to efficiency from an economic perspective.

We have offered two interpretations of these conclusions. 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 restrict 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 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 general rationale for international agreements to limit subsidies.[53]

At the least, the conclusions we report in section 2 reflect the need for further articulation of the rationale for the treatment of subsidies within the GATT/WTO. At most, the GATT/WTO's approach to subsidies might benefit from a fundamental overhaul.

Second, our analysis indicates that as a general matter export restraints should not be viewed as specific subsidies within the meaning of the SCM Agreement. We offer an argument to support this view from an economic perspective. According to this argument, an export tax can be interpreted as providing a production subsidy to *every* other sector of the economy, because its effects are conceptually equivalent to imposing an export subsidy in every other export sector and an import tariff in every import-competing sector, and each of these policies can in turn be decomposed into a production subsidy and a consumption tax. Therefore, the subsidy implied by an export restraint would not appear to qualify as a "specific" subsidy as defined in Article 2 of the SCM Agreement, and on this basis Part II, III and V of the SCM Agreement would not apply.

If the specificity requirement is sufficient to exclude export restraints from consideration within the SCM Agreement, then no changes to legal text seem warranted (though this was not the legal basis for the finding in the US Export Restraints Case). If the specificity requirement by itself would not serve this purpose, then a change in the legal text to rule out the application of the SCM Agreement in cases of export restraints seems 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 if relevant, the Appellate Body. With respect to the sequencing of analysis, as noted above, we believe that the Panel could have looked to the nature of the US measures and reached a judgment with respect to the mandatory versus discretionary nature of the measures without necessarily going the next step and undertaking a full substantive review of the circumstances where export restraints could be deemed a subsidy within

[53] In this regard, the conclusions we report in section 2 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 subsidies.

the meaning of the SCM Agreement. That exercise of judicial restraint would have been warranted and appropriate.

It is also instructive to compare the *US – Export Restraints* case to the *Canada – Dairy* case (see our companion review of that case) because both of these recent cases implicate the SCM Agreement. Consistency of interpretation is not the hallmark of these cases when taken together. *Canada – Dairy*, which concluded after *US – Export Restraints*, was a particularly noteworthy case from a legal perspective in that it represented the first interpretation of the Agriculture Agreement. However, the *Canada – Dairy* case also considered 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.

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